Canadian Trade at a Crossroads: Options for New International Agreements

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CANADIAN TRADE AT A CROSSROADS: OPTIONS FOR NEW INTERNATIONAL AGREEMENTS

Canadian Trade at a Crossroads: Options for New International Agreements

Edited by David W. Conklin
Thomas J. Courchene

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Toronto, Ontario

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David W. Conklin
Research Director and
Executive Secretary

Council preface

This volume contains the papers and proceedings of a conference sponsored by the Ontario Economic Council in April, 1985. The conference was part of a series of Council research activities concerning Canada's international trade relations. Each book in this series is being published with a distinctive cover design and with the series title *Canadian Trade at a Crossroads*.

The conference on which this volume is based included representatives from government, business, unions, and academe. Participants dealt with many issues in addition to economic aspects, including the impact of new trade agreements on Canadian culture and political identity, the attitudes of different regions concerning trade negotiations, and the mechanics for implementing an agreement and resolving disputes.

Our objective in mounting this conference was to inform rather than to persuade – in the words of our mandate, to 'create an awareness and public understanding.' Accordingly, the Council strove to ensure that those chosen as participants reflected a wide spectrum of views and disciplines. We think that we have been eminently successful in this regard.

The Ontario Economic Council would like to express publicly its appreciation to the individuals who participated in the conference and in the preparation of this volume. The Council staff deserves special thanks: Administrative Officer Sharon Wahl; Publications Officer Brenda Huff; Word Processing Technicians Tom Gerylo, James Leahy, and Sylvia Machek; Publications Assistant Kathy Ashenden; Librarian Diane Wenzel; Assistant Librarian Louise Ayotte-Zaretski;

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CANADIAN TRADE AT A CROSSROADS: OPTIONS FOR NEW INTERNATIONAL AGREEMENTS

PART I: THE CROSSROADS

Options for new international agreements: an overview

David Conklin

Since the earliest times, trade has been a central aspect of economic activity. Economies of scale and specialization, together with varying endowments of natural resources and climate, have long offered the hope of increased prosperity based upon trade. For many nations, the right of access to foreign markets and the terms and conditions of such access have consequently been issues of prime importance.

Given Canada's history of substantial trade flows, it should not be surprising that the terms and conditions of our access to foreign markets and of foreign access to our markets have been repeatedly at the forefront of public policy. Neither is it surprising that freer trade – with the United States and with other nations – is much discussed in Canada today.

Freer trade would provide opportunities for substantial increases in Canada's Gross National Product. Canadian firms would be able to sell in a larger market and to benefit from economies of scale. Canadian consumers would be able to buy more foreign-made products at prices lower than those they currently pay. Innovation would be stimulated as Canadian entrepreneurs developed new products and new production methods to take advantage of their much larger marketplace.

Yet freer trade would hurt those firms whose current costs are higher than those of foreign producers. Confronting new international competition, some firms would not survive, and bankruptcies

Dr Conklin is research director and executive secretary of the Ontario Economic Council.

and lost jobs would probably be part of the adjustment process. Some employees would have to learn new skills, and the wages for some jobs would fall. These adjustment costs have to be weighed against the gains from freer trade. An important policy issue is whether Canadian society as a whole – through its government programs – should assist the firms and employees who would face these adjustment costs if freer trade is implemented.

A basic factor in the size of the gains from trade would be Canadians' entrepreneurial capacity to take advantage of new market opportunities and to develop new skills and more economical production methods. Thus, one's calculation of the gains from freer trade must depend on one's evaluation of Canadian entrepreneurial capacity, both on the part of firms and also on the part of individual workers.

A separate issue is the degree to which Canada would be able to export to her trade partners goods and services that they had been purchasing elsewhere prior to the new trade agreements. In the United States, recently proposed protectionist measures may reduce that country's imports from other nations. A Canada/US freer-trade agreement could enable Canada to take the place of those other nations in the US market, providing Canadians with additional gains from trade.

A CROSSROADS

In what sense does Canada now stand at an important crossroads? Why is a well-considered decision so urgent? The path of trade agreements has frequently required choices among alternative directions and will no doubt do so in the future. One option is continuance of the status quo. We do not face the only opportunity to choose in this generation. In fact, one of the current alternatives – support for a new round of multilateral negotiations under the General Agreement on Tariffs and Trade – can be seen as an extension of a process developed in the Kennedy Round and the Tokyo Round. These previous sets of negotiations have resulted in a substantial reduction in tariffs, but significant nontariff barriers and protectionist policies still remain.

Two factors lend an urgency to today's crossroads. First is the opportunity to pursue freer trade bilaterally with our most significant trade partner, the United States. It is the Reagan administration that is interested in exploring the possibility, so the opportunity may be a temporary one that will disappear within a few years. Second is the fear that existing trade agreements may soon encounter severe difficulties. In particular, United States' reaction to inexpensive imports from other nations may result in its erecting new import barriers that could hurt Canadian exporters even though they may be innocent bystanders. The alternative of a new Canada/US agreement might avoid such unpleasant experiences. Thus, although we shall no doubt come to many crossroads, this one seems particularly serious.

It should be noted that lurking ahead of us, down all our alternative routes, lie difficulties in coping with the new competitiveness of less developed countries as well as the continued competitiveness of Japan. The desire to facilitate the economic growth of low-income countries and to help them meet their international debt obligations may argue for reducing our import barriers for their products. Yet the Canadian firms and employees whose profits and jobs would be hurt in this process are bound to advocate a heightening of such barriers.

It is also worth emphasizing that no new set of trade agreements will end the debate. Just as market prices constantly change to reflect changing economic circumstances, so pressures will always be building for modifications in trade agreements to correspond with changing economic circumstances. Furthermore, the interpretation of trade agreements as they apply to specific cases is also an ongoing process, much as the interpretation of our Constitution and Charter of Rights is an ongoing process. Certain issues stand out as areas of potential conflict for periodic negotiation. Governments cannot guarantee that private firms will never engage in dumping, disposing of a portion of their production abroad at lower prices than they receive domestically. Consequently, some antidumping provisions will probably be part of any agreement. Furthermore, under a flexible exchange rate regime, a shift in exchange rates can abruptly alter the international competitiveness of many firms. New foreign government programs could affect import prices. For these, among other reasons, provisions for contingent protection will also probably be part of any agreement. Such provisions, which would enable firms to request and obtain special import restrictions such as quotas when they are hurt by imports, could give rise to many future disputes and the need for formal dispute resolution procedures.

Canada is also at a crossroads in the broader sense of political identity. The debate about freer trade is a debate about the appropriate role of government. Canadian governments have developed a myriad of policies and programs that alter the relative prices of goods and services, and thereby affect trade flows. Regional development programs provide special investment assistance to firms locating in areas of high unemployment. Tax concessions attempt to stimulate a wide variety of specific activities such as research and development. Different sectors pay different effective tax rates. Government loans at less than market interest rates reduce the private costs of some economic activities. Government ownership of Crown corporations and equity investment in privately operated corporations can enable those firms to sell products and services at prices much lower than actual costs. Agricultural marketing boards and supply management can result in prices quite different from those of a free market. Negotiation and implementation of new trade agreements will involve debate about the degree to which different types of government intervention distort prices and affect trade flows, and this debate may consequently result in modifications in the role of Canadian governments. From this perspective, the trade crossroads is particularly important.

THE ISSUES IN MAKING OUR CHOICE

Choosing among several alternatives is never easy. It becomes more difficult when we can see part way down some of the routes and each offers a prospect that contains some pleasant and some not-so-pleasant elements. Some paths will be easy going for some Canadians, rough going for others. Moreover, our view is partial and from the distance of time. What looks to be a grassy meadow might turn out to be a bog, but an apparently thorny thicket may have an easy passageway.

Let us look at some of the elements of the terrain, concentrating closely but not exclusively on the paths towards freer trade with the United States.

Employment prospects and political pressures

In earliest human times, it is likely that when individuals and societies considered trade agreements, they were as concerned with the amount of imports they would receive as they were with the amount of exports they would have to surrender in the exchange. In recent years, many governments have come to focus on the ability of new trade agreements to increase exports. The importance of imports in raising a nation's income levels and living standards seems to have been ignored.

Perhaps this phenomenon can be explained in political terms. Increases in exports create jobs; increases in imports often threaten jobs and require costly adjustments on the part of domestic producers competing against the imports. For the population as a whole, an increase in imports that are less expensive or of better quality and more variety than domestic goods may be of great importance. But individual citizens do not stand to gain sufficiently to justify active lobbying for new trade agreements to increase imports. In addition, the Canadian beneficiaries of the new business opportunities created by such agreements may be future corporations and future employees, who have no voice in today's debate. On the other hand, the increased imports would hurt a relatively clear-cut group of producers and employees, who may see their potential losses as so great as to warrant powerful political lobbying. In such a situation, a government may choose not to maximize GNP but rather to cater to the vocal segment that fears it may be hurt.

The political strength of these vested interests is likely to be greater to the degree that they are clustered in a specific region or province. High concentration may automatically win the support of their provincial government. Furthermore, their cries of hardship may be more justified to the extent that regional concentration makes readjustment to new trade conditions more difficult. That is, entire communities could be compelled to transform their industrial structures, a process that is more difficult than if the adjustments were evenly dispersed across the country.

New trade agreements will always threaten to hurt some individuals, some corporations, some economic sectors, and some geographical regions. Those who fear they will be hurt not only object to such changes; quite naturally, they also often lobby for special government assistance to compensate for their losses. For Canada as a whole, such adjustment assistance may be a wise policy. In fact, we may have reached a crossroads at which any significant shift in direction will have to involve such assistance. Without it, political agreement on the pursuit of a new direction will not be possible. Thus, new trade agreements may have to include adjustment assistance as part of the arrangements.

Canadian provinces will probably be actively involved in the debate about freer trade. Tariffs have already been reduced substantially through earlier agreements, and a major focus of international negotiations will be nontariff barriers. Some of these nontariff barriers, such as procurement policies, have been put in place by provincial governments, and so provincial co-operation will be required for their reduction. Some of the government programs that distort prices from their free market levels have also been put in place by provincial governments, and to modify them may involve provincial consent. It is interesting to note in this context, that international negotiations could reduce some of these internal barriers to trade within Canada, and so could strengthen the economic union. In addition to these concerns, the creation of programs for adjustment assistance to the workers and firms that will be hurt by freer trade will inevitably involve provincial governments. Provinces will likely accept some direct responsibility for providing such assistance, and they will also negotiate federal-provincial sharing of some programs. All of this means that Canada's provinces have a leading role to play in the decisions at this crossroads. Provincial representatives will probably participate in the international negotiations. New federal-provincial agreements may be a necessary accompaniment to an international agreement.

When considering employment prospects and political pressures, a quite different perspective may deserve some acknowledgement. Over time, firms and workers lobby for government policies and programs that can entrench and protect their established income patterns. To the degree that such policies and programs are implemented, economic change may be retarded. Innovation and entrepreneurial success may be limited by the protection of the status quo. Some people argue that only a major disruption such as new trade relationships can shatter the established patterns of vested interests, releasing the entrepreneurial spirit that is necessary for substantial long-term growth.

New trade agreements could have a significant influence on patterns of international investment. This linkage could affect Canadian prosperity and growth, with a direct impact on jobs. Freer Canada/US trade might lead some US firms to close their Canadian subsidiaries and supply the Canadian market from their home base. Yet any shift of this nature could be offset by the new investment that would occur to serve the US market from a Canadian base. The entrepreneurial ability of Canadians will affect this issue, as will the climate of labour-management-government relations. Canadian cities offer a cleanliness, safety, and culture that may attract investors who see these attributes as desirable for themselves and their employees. The net amount of investment in Canada, and the location of that investment within Canada, will depend on a variety of factors such as these which are difficult to quantify or predict.

The Canadian identity and the integration of economic policies

The maintenance of a distinct Canadian identity has always been a basic concern in the formulation of Canada/US arrangements, military, cultural, political, or economic. Not surprisingly, the possibility of Canada's pursuing freer trade with the United States has usually been greeted with some anxiety in this regard. Fears even exist that closer economic integration might inevitably lead to political integration. Today's trade crossroads attracts particular attention because of this. To some degree, all forms of economic integration may alter the existing Canadian identity. So we should also be concerned about the implications of other possible trade agreements, multilateral as well as bilateral.

To what degree and through what mechanisms should new trade agreements restrict the freedom of member nations to pursue independent macroeconomic policies? Over the past fifty years, governments have acquired many new responsibilities, including those of adjusting the major macroeconomic variables, such as employment levels, interest rates, and foreign exchange rates. Yet the adjustment of these macrovariables may affect international trade flows, and vice versa. The chosen levels of taxation, expenditures, and deficits can affect domestic interest rates and international capital flows – and, consequently, the exchange rate. And changes in the exchange rate can, of course, have the same impact on trade flows as changes in the market prices of the goods being traded.

Governments around the world have adopted a myriad of programs that provide special financial assistance to particular economic activities. Funding for domestic cultural activities, including radio, television, and cinema, may be considered essential for development of a national identity. Moreover, tax structures today are extremely complicated, including a myriad of special concessions that can affect the competitive position of particular economic activities in ways that affect international trade flows. In some nations, a desire to foster equality among geographical regions has led to programs that provide financial assistance to economic activities located in regions with high unemployment, low incomes, or poor growth prospects. For Canada, this type of economic policy has become particularly significant. Yet other nations may view such programs as providing the recipient firms with an unfair competitive edge and so may negotiate for their reduction or elimination as part of a new trade agreement.

A related type of policy has been investment by governments in equity of corporations which are then able to price their products on other than a competitive market basis. Would freer trade entail restrictions on the pricing policies of enterprises that have government shareholders? What would freer trade mean for Canadian marketing boards, production quotas, and price support programs in our agricultural sector? Would foreign negotiators insist on common product standards? Would they insist on common regulatory systems? Would the integration of some policies (environmental controls, for example) be in the best interests of the Canadian identity?

Some observers even fear that Canadian programs of income redistribution and social assistance could be compromised. Canada's unemployment insurance program, for example, might be attacked as providing firms in some areas with lower wage levels than they would otherwise have to pay. Hence such firms could be seen by foreign interests as having an unfair competitive advantage. From a different perspective, the need to compete with foreign firms might create domestic political pressures to alter Canadian labour legislation and the regulations that have been designed to protect consumers, since such programs and policies may add to the cost of Canadian goods.

Recent years have witnessed considerable anxiety about foreign investment in Canada, particularly in sectors which are considered to be essential to the Canadian identity. Both the Foreign Investment Review Act (FIRA) and the National Energy Programme (NEP) imposed restrictions and constraints on foreign investment. Such concerns about Canadian ownership may clash with the belief that new investment – whether by foreigners or by Canadians – is beneficial in its provision of employment opportunities. Replacement of FIRA by Investment Canada and modification of the NEP will probably make foreign investors feel more welcome. Negotiations about freer trade, however, may involve the request that many of the other Canadian restrictions on foreign ownership also be removed.

A particularly thorny issue is the appropriate role of government in export promotion. With free trade, one could expect that the marketplace would determine the most efficient patterns of production and trade, so no such government involvement would be necessary. At most, a government might provide broad productivity programs, equally accessible to all types of firms, that would stimulate R&D and improve production technologies. However, many governments have accepted responsibility for picking winners in the export field and providing them with special assistance to increase their international competitiveness. One can question the ability of governments to pick winners successfully (as opposed to leaving this to the marketplace). One can also expect that negotiations for new trade agreements will attempt to limit such assistance. Some international agreements have already sought, for example, to limit the hidden subsidies of lower-than-market interest rates on government loans to exporters.

Given these government economic policies, some see merit in advocating a shift towards freer trade rather than to free trade. Completely free trade could require a much diminished role for governments – a diminution that Canadians may be unwilling to accept. That is, our Canadian view of the role of government may simply prevent a shift to trade that is completely free. The Canadian identity or self-image may preclude some of the options which we face at our crossroads.

THE MECHANICS OF CANADA/US NEGOTIATIONS

Multilateralism

At today's crossroads, an important question is whether it would be practical to follow a path that involves both negotiations for freer Canada/US trade and a new round of multilateral negotiations for freer world trade. Also of concern is whether freer Canada/US trade can be pursued without hurting future trade opportunities with other individual nations. Special concern focuses on Japan since many see particular opportunities in freer Canada/Japan trade.

This issue, like most of the others, emphasizes for us that the detailed content of a new Canada/US trade agreement – and the interpretation and enforcement of that content – would be both important and complicated. Under what terms and conditions could products from other nations enter the North American freer trade zone? How much North American value would have to be added to foreign imports for them to qualify as North American products that could be traded freely?

Sectoral negotiations

Some analysts advocate a gradualist approach to freer trade, proceeding along a sectoral path. The classic Canadian/US sectoral agreement is the Auto Pact, but Americans tend to view it as the result of an exceptional situation, not as a prototype for future sectoral agreements. They note that the automobile industry involves basically the same few firms and until recently, the same trade unions on both sides of the border, so that gains on one side offset any losses on the other side. Most industries, however, comprise more firms and unions, and the participants are different in each country. Consequently, some firms and unions could expect to suffer losses in sectoral free trade without experiencing any offsetting gains. Of great significance is the general expectation that these threatened interests would lobby effectively to forestall such agreements.

Since most industries consist of many firms and produce a wide variety of products, it is difficult to predict the effects of free-trade arrangements for particular firms or products and, consequently, to design appropriate transitional assistance to the firms or workers that would be hurt. Safeguards like those included in the Auto Pact, which reserve a particular percentage of the North American market for each nation, would also be complicated and difficult to justify. Furthermore, such safeguards are not likely to be accepted by the United States, where the Auto Pact is viewed as an exception, as is the Defence Production Sharing Arrangement. It is also expected that other nations would object to more sectoral free-trade agreements and would seek to prohibit them.

The US administration sees itself as championing the interests of the general public and thus supports initiatives that appear to aid the general public. It would be difficult for the administration to present any one sectoral agreement as being of great public value, and one can expect that some special-interest groups would lobby against it.

Bargaining strategies

Questions also arise about the formation of an appropriate strategy for Canada in negotiating the details of any new Canada/US agreement.

In view of the important role of the provinces – as creators of nontariff barriers, providers of financial subsidies, and key participants in any industrial readjustment – such a bargaining strategy would have to involve the provincial governments and perhaps even the governments of large municipalities, which also have major responsibilities.

Canada's relatively small market size, compared with the US, means that Canada may have proportionately greater adjustment problems. US production facilities have already adjusted to competition in a large market. Consequently, Canadian negotiators may seek to achieve asymmetrical restructuring arrangements in regard to the timing of implementation, exceptions to the agreement, and provisions for government assistance. The extent of such concessions could affect the degree of adjustment difficulties in Canada, and hence the political acceptability of an agreement. Canada's relatively small size also raises anxieties about its ability to negotiate and to settle disputes with its much larger neighbour. Can procedures be established to ensure that the differences in size and strength will not preclude fairness in these processes?

Bargaining strategies often work best if kept secret. Canadian negotiators would face a most difficult task if they constantly had to defend their positions in public. For Canada's political leaders and negotiators to present their demands and tradeoffs in the media could well result in a diminution of the benefits to be gained from the bargaining process.

The Reagan administration obviously views trade relations as an important component of its foreign policy. It seems prepared to suffer domestic political criticism from threatened vested interests in order to improve its trade relations with Canada. Much more than economic calculations can be involved in trade decisions, and the US administration may well yield concessions of real economic value to Canada in order to achieve more general foreign-policy success.

The US system of government involves many somewhat-independent pressure points, each of which may respond to different forces. Each decision about the various components of a new Canada/ US agreement may evoke reactions from a different combination of political forces. Trade negotiations must be based on an understanding of the US decision-making process, which differs considerably from the Canadian cabinet-parliamentary system. Furthermore, negotiations must be based on the recognition that in the United

States the division of powers and responsibilities among federal, state, and municipal authorities differs in important respects from the division in Canada.

The agreement

Many significant questions concern the mechanics of negotiating new agreements, and the nature of the issues to be included in the agreements.

– Should states and provinces sign the agreement, formally promising to restrict their activities in accordance with its terms? Should some municipalities have to sign as well?
– Should programs of industrial adjustment assistance be a part of the agreement, recognized internationally as essential to its political acceptability?
– Should the agreement be phased in over time, perhaps with 'trigger points' on imports to prevent a sudden flood of imports that could create special hardships?
– Should the signatories establish some new institution of judicial appeal – perhaps a joint tribunal – so that anyone who claims to be hurt by a violator of the agreement could seek rapid retribution? For businesses, justice delayed can mean financial disaster, so a new judicial body with powers of enforcement might be necessary in order to implement the agreement fairly.
– If we are moving to freer trade rather than free trade, which economic sectors or government protectionist measures should be addressed first?
– In a Canada/US agreement, could the Auto Pact remain as it now is, or would it be seen as an anomoly that should be eliminated?
– What provisions should be included concerning trade with non-signatories?
– Should some government subsidy programs be undertaken jointly, with the signatories agreeing to pool their financial assistance to specific activities such as research and development or to specific sectors such as aerospace?
– To what degree can current administrations bind future administrations?

– What notices would be required before one of the nations could abrogate the agreement? What provisions should be included to protect businesses in the event of abrogation?

CONCLUSION

All these issues emphasize the complexity of choosing among the alternatives facing us at this crossroads. None of the paths is simple and clear. In particular, a commitment to freer Canada/US trade would be a commitment to negotiate and adjudicate indefinitely into the future. At the core of this process would be agreements about the appropriate role of government, about acceptable types and degrees of government intervention.

The world trading environment and Canadian trade policy

Sylvia Ostry

The American columnist George Will once wrote, 'Few things are as stimulating as other people's calamities observed from a safe distance'. Perhaps there was a time when that would have been true of nations as well as individuals. But in today's interdependent world, there *are* no safe distances.

How a country views its self-interest may depend on the length of the view it takes. In the short run, a competitive threat to a major industry or a balance of payments crisis seems more real and compelling than more distant dangers to the world trading system. At various times in our history, actions taken by large numbers of countries to protect their short-term interests have had a cumulatively damaging effect on the stability and efficiency of international trade. There is evidence that this has been happening again, during the past fifteen years. The single most important challenge to trading nations today is to halt and reverse this process.

THE DEVELOPMENT OF THE PRESENT SITUATION

In the early postwar years, the experiences of the 1930s were still fresh in the minds of those who constructed the General Agreement on Tariffs and Trade. During much of that decade, countries had sought to solve domestic economic crises by 'exporting' their problems to the rest of the world through tariff protection, quantitative restrictions, exchange-rate devaluation, exchange controls, and other trade-restraining devices. This process had developed rapidly into esca-

Dr Ostry is deputy minister of External Affairs Canada.

lating retaliation and produced what Arthur Dunkel, the director-general of the GATT, has described as 'a panic-stricken run for cover'.

It was to prevent such disruptions that the GATT was created after the Second World War. The aim was to establish norms of behaviour for the governments of countries involved in trade. It was hoped that these norms would promote stability and predictability in trade policy and, subject to various constraints and exceptions, allow the underlying market forces of international trade to operate. Where exceptions were allowed, the norms would make them 'transparent', so that everyone affected would know that they had been made, how they worked, what purpose they were intended to serve, and what the cost implications were for other traders.

Today, however, that system of norms has proven vulnerable. Nations are once again faced with domestic economic problems that they are tempted to ease through trade-distorting measures – both a widening range of nontariff border measures designed to restrict the inflow of competitive goods from abroad and domestic policies, including a variety of subsidies to selected industries, export financing, and procurement requirements, employed to prop up dying industries or to launch new ones on import-competing and export markets. The extent to which these measures adversely affect the open international trading system varies, depending on their purpose and how they are used.

Although the erosion of the system has been gradual and not highly visible, it has not gone completely unnoticed. In 1982, the GATT ministerial meeting resolved 'to make determined efforts to ensure that trade policies and measures are consistent with GATT principles and rules'. Six months later, the ministerial meeting of the Organization for Economic Co-operation and Development agreed that member countries should take steps, individually and collectively, to halt and reverse protectionist trends. But these declarations of intent were a paraphrase of St. Augustine's prayer: 'God, help me to stop sinning – but not just yet!'

True, not many people expected immediate action. The world was in the trough of a deep recession when the GATT ministers met, and even by the time of the OECD meeting, the signs of recovery were still tentative. Recession always dampens enthusiasm for trade liberalization. But the world is now in its third year of recovery, and little progress has been made in halting and reversing protectionist action.

One reason is that there are doubts about the breadth, depth, and durability of this recovery. At first glance, the economic performance of industrial countries in 1983 and especially in 1984 is cause for celebration. In 1984, real output in the OECD countries expanded by 4.8 per cent, the strongest rise since 1976. Inflation, at 5 per cent, was the lowest since 1972. Economic growth in 1985, while less than that of last year, is expected to be a respectable 3 per cent with no acceleration in inflation.

But closer examination reveals some problems and helps to explain why nations have been so slow to act on the multilateral commitment. The recovery is very uneven in two senses. It is unevenly distributed among various regions of the world, and it is unevenly distributed among various economic sectors within individual countries. Both kinds of imbalance tend to prolong some aspects of the uncertainty that gripped the world during the recession, uncertainty that has placed obstacles in the way of efforts to liberalize trade.

The imbalance among economic regions is most evident when one compares the performance of Europe with that of the United States. Last year the rate of real GNP growth in the United States was approximately three times that of Europe. Japan's growth rate was two-and-a-half times that of Europe, and Canada's rate was double Europe's. Japan's unemployment, which has always been comparatively low, remained less than 3.0 per cent last year and the US rate fell from 9.5 to 7.5 per cent. Unemployment in the European countries of the OECD, however, held at 11 per cent; the total number of unemployed people there is now approaching 20 million and shows no sign of dropping over the next few years. Protectionist sentiment in Europe is being fed by its sluggish growth and persistently high structural unemployment.

Protectionist tendencies are also evident in other regions, although for different reasons. For example, although the United States is doing very well in terms of both aggregate growth and employment generation, it faces special problems. The strength of the US dollar – itself a product both of the dynamism of the US economy and of fiscal and monetary policy – has helped to produce a large and growing US trade deficit. This deficit has had two quite different impacts on the US economy. On the one hand, it has had positive effects, forcing both import-competing and exporting industries to increase their competitiveness through structural change and other adjustments. On the other hand, it has increased the pressure for US protectionism on behalf of industries that feel threatened by the increased international competition. (Indeed, some firms see no inconsistency between undertaking positive adjustment and demanding protection at the same time.)

Of course, what produces protection is not the pressure itself but the response of policy authorities to such pressure. So far, the US administration has been fairly successful in resisting calls for additional restrictions on trade. However, it will face increasing difficulties in mobilizing the support of industry and labour for an acceleration of trade liberalization. This is a critically important point, because the success of any new round of multilateral trade negotiations will depend primarily on US leadership.

Canada's recovery also reveals some imbalances. So far, we have been pulled along by the US locomotive in an export-led recovery, but the spinoffs from the foreign sector to the rest of the economy have not been as powerful as we might have wished. Real investment in plant and equipment increased only marginally in Canada last year. Our unemployment rate remained around 11 per cent and is still substantially above that of the United States.

ARGUMENTS FOR TRADE LIBERALIZATION

Some people in all countries argue that the imbalances of the present recovery do not favour a move to trade liberalization at this time. In my view, that is looking at the problem backwards. Many of those same imbalances have their roots in the inflexibility of domestic markets and institutions, and those rigidities, in turn, are reinforced and prolonged by trade restrictions. Trade liberalization, far from making the imbalances worse, should help to correct them.

In the case of Canada, trade liberalization would help to improve our competitive position. Many of the forces shaping the international environment may be beyond our control, but being so dependent on trade, we have no real alternative to competing in that environment.

How are we doing? In the last three years, not only have we run huge surpluses in our trade in goods, but those surpluses have been large enough to outweigh our deficit in services. So our overall current-account balance has moved into surplus. That, for us, is a rare achievement. However, special recent circumstances, including the rise in the US dollar and the buoyancy of the US economy, helped to produce that result. Closer examination suggests that our underlying competitive position has a number of vulnerable points.

There is no composite index of competitiveness, but a number of Canadian indicators, including productivity growth, market share, unit labour cost, comparative research and development effort, and other measures usually associated with competitiveness are far from reassuring. A concerted effort to increase our competitiveness through education of the work force, technological change, and shifting out of obsolete industrial structures is essential.

Those are actions that we can take at the domestic level. At the same time we must work vigorously for an open international trading system. Improving our ability to compete in a rapidly changing and increasingly tough world environment depends to a very large degree on open trade. In many industries, our domestic market is too small to permit optimum plant size and product specialization. A more open market would have two effects on Canadian competitiveness: it would permit us to achieve economies of scale, specialization, and other benefits of a larger market; and it would give us the needed push to make the necessary adjustments and resource reallocations. Those are two of the main reasons we are deeply concerned with maintaining and enhancing the open system that has served us so well.

Economic relations with the United States, which have always been a Canadian preoccupation, have recently commanded even more of our attention. In the 1960s, on an annual average basis, 60 per cent of Canadian exports went to the United States. This average rose to nearly 68 per cent in the 1970s. Last year, it was 76 per cent.

The sharp rise in this figure in the last few years may be a deviation from the trend, provoked mainly by the strong US dollar. But there are other forces acting here as well. As we have seen, demand is growing very slowly in Europe but booming in the United States. This phenomenon is reinforcing the shift in our trade pattern. Therefore, even if the present currency misalignment is corrected, the structure of growth in international demand will help to pull our exports towards the United States (and towards Japan and the Pacific Rim as well).

Other special factors, such as proximity, mobility of capital, intra-corporate exchanges, similar economic structures, and the Auto Pact, are also conducive to close trading links between Canada and the United States.

THE CANADIAN AND OTHER POSITIONS

The recent federal government discussion paper *How to Secure and Enhance Access to Export Markets* (Kelleher 1984) examines options and opportunities for trade liberalization in terms of both the next round of multilateral trade negotiations and our bilateral trade relations with the United States. It examines the sources of actual and potential protectionism in the US market and weighs various options for securing and enhancing our access. This approach will provide a framework for the Canada/US discussions on trade enhancement that were announced during the visit of President Reagan here in May 1983.

Whatever form these discussions take, Canada will continue to press for the preservation and strengthening of the multilateral trading system. Our ultimate economic and political interests – like those of all industrialized market economies and especially the smaller countries – are best served by an open international system. Indeed, the example of successful Canada/US trade-liberalization efforts would be seen as an important contribution to energizing the GATT.

If the system is to survive and grow, we cannot afford to be satisfied with the accomplishments of the Tokyo Round. By the time its reductions are completed in 1987, the industrialized countries will have cut tariffs on industrial products, on average, by about 30 per cent from their pre-Tokyo Round levels. But the Tokyo Round took only limited steps in dealing with nontariff barriers, and these are now the most serious obstacles to trade.

The Canadian government believes that it is important to begin a new round of multilateral trade negotiations as expeditiously as possible. We subscribe to the bicycle theorem: if the trading nations do not move forward, they risk falling off. Canada, in partnership with the United States and Japan, has been pressing its GATT partners to reach an agreement sometime this summer on the establishment of a preparatory committee that would pave the way for a round of negotiations to begin early next year. This critically important issue was discussed at the OECD ministerial meeting in April 1985, and agreement to establish the preparatory committee was, indeed, reached. The date of the new round will be high on the agenda at the Bonn economic summit next month.

Although the United States, Japan, and Canada are agreed on the need to set a date to begin negotiations in early 1986, the EEC is somewhat more equivocal. Last month, its council officially declared its willingness to participate in launching a new multilateral round, subject to 'adequate prior international consensus on objectives, participation, and timing'. The EEC has stressed the importance of achieving a consensus with the less developed countries (who themselves do not agree about the timing and agenda of the round) and has also expressed deep concern about the impact of monetary instability on trading patterns.

Among the developing countries, there is still a certain amount of skepticism about the commitment of the major trading powers to restoring the momentum of trade liberalization. Many LDCs are concerned both that a new round would do little to end those practices used to discriminate against them and would also reduce or even eliminate their present privileges. Yet it is evident that the LDCs have the most to lose from a continuing erosion of the multilateral trading system, and some – especially the newly industrialized countries of Asia – are persuaded that participation in the round is the only way to promote their long-run interests. Many developing countries took no part in previous GATT negotiations; during the Kennedy and Tokyo rounds a disproportionate number of exceptions to across-the-board tariff cuts were for products of special interest to developing countries, with the consequence that tariffs on those items remained higher than on other products.

Many LDCs, as exporters of agricultural and other resources products, have export interests and objectives similar to Canada's. When developing Canadian objectives for the next round, therefore, we are hoping to work more closely with these countries than we have in the past.

More fundamentally, the LDC's participation in this round will be essential because the ultimate resolution of the global debt problem is so dependent on their having access to the markets of OECD countries. According to the World Bank, the exports of developing countries must grow at 5 per cent per annum in real terms during the rest of this decade to permit a GNP expansion of roughly 5 per cent and thus to allow debt/service ratios to improve. This export growth is feasible – though it is higher than the expected, sustainable growth of the OECD countries – but only if protection in industrialized countries' markets is halted and reversed. If protectionism increases, growth in the highly indebted countries will fall sharply, as will their ability to service existing debt and to attract new capital inflows. The multilateral system is now a seamless web: strains in the trading system will seriously exacerbate the international monetary system and vice versa. Will Canada be able to observe this from a safe distance?

SOME AGENDA ITEMS

According to one OECD estimate, the absolute number of nontariff barriers has *quadrupled* over the past two decades. Dealing with these devices is probably the single greatest challenge facing the next round of multilateral negotiations.

One of the most important questions on the agenda will be the development of a code on emergency safeguard actions. In the talks currently underway, the focus is on time limits, degressivity, surveillance, and transparency. If safeguards are to be phased out over time (and the OECD ministerial meeting last week endorsed such a proposal), the protected industries will be under pressure to undertake major structural adjustments, and this pressure will increase as economies become more interdependent. OECD countries will need to adjust more rapidly as heavily indebted countries shift to export-led growth. Unfortunately, history teaches us that the pressure to adjust is often met with demands for increased protection.

A new safeguards code could also help to cope with the problem of 'grey area' measures, such as voluntary export-restraint agreements and orderly marketing arrangements, which are now negotiated outside of the GATT. These measures are especially pernicious because they can create vested interests in the exporting country, by encouraging both the production of more high-priced articles and through enhanced scarcity rents on the quota itself.

With regard to particular sectors, two agenda items of special interest to Canada will be agricultural products and a broad range of resource products in the fisheries, forestry, and mining sectors. As to the former, GATT must develop more effective rules on agricultural subsidies (both export and domestic) and more open access to markets. For other resource products, the secular decline in our terms of trade (exacerbated by currency misalignment) means that we must try to move up the processing scale and aim for lower tariffs and other barriers to higher value-added products.

Textiles and clothing is a sensitive area, but it must be dealt with if the interests of a number of developing countries are to be taken into account. This issue will have to be confronted very soon in any case because the Multi-Fibre Agreement expires in mid-1986.

The United States is pressing for an extension of GATT jurisdiction to trade in services, which now amounts to more than 25 per cent of the total value of international trade in goods but is not specifically covered by GATT obligations. Canada is a significant exporter and importer of services. We are examining this issue carefully, and we will want to ensure that any agreement negotiated under this item accommodates Canadian interests.

These agenda items are among those that will probably receive most attention in a new round of multinational trade negotiations or are of particular concern to Canada, but this list is by no means exhaustive. Moreover, it is impossible to convey the complexity and difficulty entailed in achieving agreement on these items, many of which may be perceived by the contracting parties as essentially in the realm of domestic, not international, policy.

CONCLUSION

There is no way to guarantee the success of a new multinational round or of bilateral negotiations with the United States. But there *are* no risk-free courses. Inertia, in the long run, would probably prove the most reckless option of all.

What is at risk is the carefully constructed postwar edifice of multilateral discipline designed to ensure the stability and predictability without which market economies cannot function. The slow, relentless erosion of that system is dangerous precisely because the process is not clearly visible, thus creating a false air of security and an illusion of stability. We live in a world vastly more interdependent than the architects of the GATT could have imagined, so harmony, order, and predictability in international economic relations are more essential than they have been. This should be the guiding principle for our approach to new trade arrangements in the current era.

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Free trade or fair trade: a question of who profits

Clifford G. Pilkey

In this discussion I first want to challenge a few of the basic assumptions that underpin the arguments favouring free trade with the United States. Modern economists are taught in a tradition that ascribes overwhelming importance to the free market and so, makes open borders the holy grail of international trade. This tradition assumes that nations will expand exports of commodities in which they have a natural or comparative advantage and import goods that other nations produce more effectively or more cheaply. In the ebb and flow of trade, all will work out for the best, maximizing prosperity for people in all societies.

Assuming that such a state of affairs is the most desirable – or at least most economically 'logical' – theorists have developed a series of arguments in support of free trade. First, it is argued, the growth of the international trading system is directly responsible for the growth of real incomes throughout the world. Second, trade is seen as especially important to Canada since exports account for almost 30 per cent of its national income. Some claim that as many as 3 million jobs depend on this trade. Third, Canadian tariffs are said to have depressed Canadian personal incomes. As early as the 1950s, T.H. Young claimed that this loss was equivalent to about 4 per cent of the Gross National Product (1957, 3). Later, more sophisticated studies, such as Wonnacott and Wonnacott (1967), suggested a cost of about 4.5 per cent. In a later study, Ronald Wonnacott (1975) argued that the elimination of American and Canadian tariffs would together

Mr Pilkey is president of the Ontario Federation of Labour.

raise Canadian personal incomes by as much as 10 to 15 per cent.

Fourth, it is argued, free trade with the United States would lead to greater Canadian specialization and production runs that are longer and more efficient. In theory, this would make Canadian industry more competitive in the American market and perhaps even off the continent. Proponents of this position go on to claim that an investment boom would surely follow, leading to greater employment, rising incomes, and most of the other good things in life.

Fifth, people argue that free trade with the United States would not be a big step since the latest round of tariff cuts, which will be in place by 1987, will have essentially the same effect. Those cuts will leave 95 per cent of Canadian industrial exports to the United States with tariffs of 5 per cent or less and 81 per cent of US exports to Canada in a similar state. So why not go all the way?

DEBUNKING THE ARGUMENTS

Let us take these arguments one at a time. The 'fact' that the international trading system has increased real incomes and has been essential to worldwide prosperity is not as well established as most economists claim. The immense wealth of the European empires, particularly of the British Empire up to the First World War, was based less on free trade than on very specialized and controlled trade with a vast colonial empire. The British market was usually allowed to operate without interference only for particular commodities, rather than for the entire range of goods in international trade.

In the case of the Third World and perhaps even in the special Canadian case, international trade has led to excessive specialization, to extensive dependence on specific commodities that are usually only semiprocessed or in a raw state, and to a general, major distortion of the processes of economic development. Even a brief examination of the economic history of developing countries suggests some serious doubts about the effectiveness of the free-trade argument.

The export trade – in what?

Now let us look at the argument about the importance of export trade to the Canadian economy. Although there can be no doubt about the proportion of national income that comes from that trade, we should seriously question the figures about the numbers of jobs it affects. Perhaps more importantly, we should look at the structure of our exports, as opposed to our imports. The sizeable surpluses accumulated in the last few years in our commodities trade hide vast variations among categories of products. Canada has a tremendous surplus in the trade in resources and partially fabricated materials and a massive deficit in manufactured end products. Generally, many of the former kinds of goods are very capital intensive; producing manufactured goods requires more jobs and provides a more stable economic base. In other words, Canada's overall trade surplus hides a very heavy reliance on imported manufactured goods.

In fact, one could well argue that Canada is the most industrialized of the developing countries. Our trade profile, aside from its sheer volume, comes close to the profiles of the exploited and dependent Third World countries. Thus, Canada is not a trading nation like other industrialized nations. We have only a limited number of manufactured products that are in demand around the world for reasons of design, quality, or cost. Science Council studies (1984; Britton and Gilmour 1978) point to the relatively low levels of research and development carried out in Canada, at least partly as the result of the high degree of foreign control in our economy.

Raising whose incomes?

The third category of argument favouring free trade suggests that it would raise Canadian incomes. Although I have serious doubts about the nature of the models used, it does seem clear that free trade might raise some incomes – and that it might seriously depress others. The industries of the American South, with their terrible working conditions, low standards of health and safety, and substandard wages, could well become the benchmark for Canadian manufacturing. As a result, the incomes of Canadian working families could be seriously depressed.

At the same time, unlimited access to the American market might raise incomes in some kinds of Canadian businesses and for some Canadian individuals. Many of the studies comparing American and Canadian incomes fail to take into account the impact of social services, such as medicare, that raise living standards or at least the quality of life in Canada while imposing a tax burden on the population. Total economic absorption into the United States would probably yield a Canadian income profile very similar to that of the United States.

Would investment follow specialization?

Fourth, I am skeptical about the arguments based on the likelihood of longer production runs and their apparent efficiencies. Numerous modern studies suggest that the day of the traditional North American factory turning out a limited number of products in vast efficiency-maximizing runs is probably already gone. High-volume, low-skill production has already begun a major, determined shift to Latin America and the countries of the Pacific Rim, where labour costs are dramatically reduced through low wages, lack of health and safety standards, and often authoritarian work environments. Microelectronic technology seems to point to a future of smaller plants and much more decentralized production. Many North American firms are now moving in this direction.

Further, the branch-plant nature of most Canadian manufacturing suggests that free trade would not necessarily bring greater investment to Canada. Large American firms might simply decide to supply the small Canadian market from the United States. In a recent *Financial Post* story on free trade, a senior executive of a major US-based office-equipment firm said, 'If there were free trade there would be less investment. The company would seek to supply its present Canadian customers from its US plant' (5 January 1985, 1).

Many of the branch plants were located in Canada only because of the Canadian tariff system. The elimination of those barriers would make it rational for many of these firms simply to concentrate production in the United States, especially in the South, where labour costs are lowest. Instead of the expected investment boom, we might well get a sharp reduction in investment in some kinds of industries and a shifting of production out of the country. The effect on Canadian workers would be dramatic, if not disastrous.

Maintaining production in Canada under free-trade conditions would depend entirely on the productivity and competitiveness of the Canadian plant. These criteria would immediately lead to the accelerated introduction of labour-saving technology and to a competitive environment that would drive workers' wages and living standards to the lowest common denominator. They would create enormous pressure to eliminate many of the protections workers now enjoy in health and safety, seniority, work rules, minimum wages, the right to organize and bargain collectively – the list is endless. The pressures might not be as great in every case as those that led Allen Industries to close in Hamilton to move to a free-trade zone in Mexico where labour costs are approximately 99 cents an hour. Nevertheless, they would be great.

The American states with the greatest concentration of manufacturing employment are North Carolina and South Carolina. Both are 'right-to-work' states, and both have average incomes near the bottom of the US scale. The investment boom the theorists associate with free trade is liable to come about only if the incomes of Canadian workers are seriously depressed and many of the services now provided to them eliminated. If that did not to happen, the transnational firms would simply move their investments elsewhere, taking with them even the jobs that now exist.

Trade without safeguards?

The fifth argument suggests that tariffs are already heading towards the zero level and free trade would simply speed up the process. This argument is as false as most seductive ones are. Free trade entails the elimination not just of tariff barriers but of the full range of nontariff barriers and restrictions as well. Often the Auto Pact is held up as an example of free trade. In fact, it is nothing of the kind. Tariffs on automobiles and parts were eliminated in return for some very specific guarantees about production in Canada. Patrick Lavelle, president of the Auto Parts Manufacturers Association recently made this statement:

> Those who favour free trade with the United States, and use the auto pact as an example, forget or disregard the fact that the auto pact includes safeguards that require certain activities in Canada . . . *without those safeguards there would be no automotive industry in Canada.* (*Globe and Mail*, 1 February 1985, B-15, italics added)

By definition, free trade implies the existence of no safeguards, no interference with the operations of the free market.

No one should be under any illusions. Free trade would lead to the almost immediate elimination of a range of labour-intensive industries in Canada – textiles, clothing, food and beverage, furniture, and machinery are examples that come to mind immediately. Others would surely follow. Although the economic models generally suggest that other kinds of activity would take their place, creating alternative jobs, it is clear to the labour movement that this would happen only if there were a major decline in the quality of life of Canadian workers.

THE LIKELY EFFECTS

Instead of the beneficial effects touted for Canada/US free trade, I foresee a number of immediate, undesirable results:

- Manufacturing activity in Canada would decline. Several sectors would be eliminated, especially those with labour-intensive firms.
- Unemployment would increase in the short term because of the shutdown of 'losing' industries. In the longer term, we would also see unemployment because of the likely shift of production away from Canada.
- Workers would be under enormous pressure to make significant concessions on wages, working conditions, and living standards.
- Canada's traditional position as a supplier of resource commodities would be reinforced.
- Both Quebec and Ontario would suffer severe economic dislocation. Incomes would be seriously eroded with consequent serious effects for the social and political structures of those provinces and for the nation as a whole.

Beyond these direct economic costs, serious political ones must be considered. Very simply, Canada's sovereignty would be seriously eroded and ultimately destroyed by the effects of free trade with the United States. Free trade implies the full economic integration of Canada with the United States and would signal the end of the process that started with the arrival of the first American branch plant in this country. Canada already finds it almost impossible to take an international stance that might oppose the interests of the United States. Once we were locked into a position of complete economic integration, we would be fully and finally dependent on American will.

Even Ronald Anderson of the *Globe and Mail's* Report on Business, who is a free-trade advocate and hardly a staunch supporter of the labour movement, recognizes that:

> There is a risk, though, in the fact that membership in a free trade area would be a much more irreversible option for Canada than it would be for the United States. In a fully rationalized Canadian-US economy, US companies would have a limited reliance on the small Canadian market but Canadian companies would be heavily dependent on sales in the United States. (1985)

In this situation, an American threat to terminate the agreement would be almost impossible to resist, even in areas not related directly to the economy.

Furthermore, eliminating nontariff barriers would also seriously undermine our capacity to make decisions as a nation. For example, our tax policy would have to be fully integrated with that of the United States. The entire range of our marketing systems and supports for farmers would have to be eliminated. Regional development grants would have to go, because they would be seen as providing unfair assistance in the context of a free market. The activities of Crown corporations, such as Ontario Hydro, might be argued to benefit from government assistance, in contrast to the situation of the largely privately owned utilities of the United States. Our publicly operated systems of workers' compensation and medicare, which are far less expensive than the privately run systems south of the border, might be argued to provide 'unfair' assistance to Canadian business. The list is almost endless, but it's not imaginary. Lumber interests in the American Northwest have been making a case for countervailing tariffs against Canadian products because of our practice of providing leases on public lands (as opposed to systems of private property ownership there).

THE BASIC QUESTIONS

Essentially, a decision to enter a full free-trade arrangement with the United States would be to follow a system of economic logic that is in itself suspect and that would create a framework within which we would have to rethink our concept of ourselves as a nation. What kind of country do we want to live in? Do we want to maintain a system of public services that secures a decent, civilized standard of living and quality of life for Canadians? Do we want to maintain standards of work and occupational health and safety that meet the needs of working people rather than the needs of profit? Do we want to maintain the potential for cultural development and diversity that can keep Canada unique in an increasingly homogenized world? I say that we do. And I say also that the impact of free trade would be to undermine our capacity to do these things in a serious way.

I also question the premise that the economic future of this country lies in export growth at all costs. Unless we can find ways of shifting away from the emphasis on resource exports and develop mechanisms that allow us to produce more manufactured goods here for the Canadian market, we will be forever caught in a spiral of depending on diminishing resources that leaves vast numbers of people without any genuine opportunity to find real and satisfying work. Given a free-trade pact, such a shift would simply not be possible.

Let us return for a minute to the basic assumption of liberal economists that the forces of the free market in international trade will lead to the best possible economic arrangement. Lay aside the fact that most of them have not believed that about the domestic economy since the 1930s, perhaps earlier. Instead, consider that a free-trade pact would be negotiated between two parties, one of whom holds almost all the cards. The American economy is ten times larger than ours. Almost two-thirds of our industry is American-controlled. We are a part of the American defence system. Free trade among theoretically equal partners might have some benefits for all of them, but free trade between partners as dissimilar in power and size as Canada and the United States would most likely lead to significant benefits for the larger and more powerful party.

In pursuing free trade with the United States, we are entering a chump's game in which there would most likely be only one winner – and it wouldn't be us.

A PROPOSAL FOR FAIR TRADE

The Canadian labour movement has consistently proposed an alternative that we call *fair* trade. We believe Canada should plan fair-trade arrangements with our trading partners through measures that emphasize several vital factors:

- Canadian content. The United Auto Workers' proposal is an example of planning for fair trade. Basically, it states that any company wishing to sell in the Canadian market must commit itself to providing a certain share of the jobs and investment in this country. For the auto industry alone, this approach would mean an additional 50,000 jobs in Canada.

- Import replacement. Our trade deficit in manufacturing products was approximately $21 billion in 1983, which amounts to the loss of some 200,000 jobs. A program to determine the domestic availability of goods being imported and to encourage the domestic production of now-imported goods would produce thousands of jobs for Canadian workers.

- Domestic procurement. A program promoting Canadian production would gain impetus from an aggressive buy-Canadian policy – particularly one for manufactured products. Some analysts of federal and provincial purchasing think that nearly half of every dollar spent on manufactured products goes out of the country. With our governments' purchasing capacity of some $60 billion a year, switching these purchases to Canadian manufacturers would provide a substantial incentive for increased domestic production.

- Industrial offsets. Large-scale resources projects could also bolster the domestic manufacturing sector if purchasing-performance standards applied to firms awarded major contracts. Having new Canadian enterprises provide the equipment for, say, the production of offshore oil (drilling rigs, floating platforms, and so on) would encourage the development of technologies and products that would have application elsewhere in the world.

- Research and development. In the past ten years, 94 per cent of all the patents granted in Canada have been granted to foreigners. Although our level of R&D is increasing, it is still well below the standard of the leaders in the industrialized world. This lack has been partly responsible for the steady decline of our secondary manufacturing industry. A commitment of 2 per cent of our GNP to research and development would help to develop our technological competence and upgrade our domestic manufacturing base.

A trade policy that is beneficial for Canada is basically an intelligent and planned industrial policy that aims primarily at providing jobs and stable incomes to Canadian citizens. If we accept as our sole priority the need to be internationally competitive, we will subordinate the principles that have guided our development thus far to the new economic reality.

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Options for Canada/US trade: a business view

Alton S. Cartwright

The subject of Canada/United States trading relationships is topical, of great importance to Canada, and deserving of full examination. My perspective is that of a Canadian businessman facing a new competitive challenge and, at the same time, looking south at a potential solution to it – at a market of enormous opportunity. The key question is how the existing positive relationship can be maintained, managed, and enhanced.

Tariff-free trade with the United States is not really an issue. It is virtually a fact. And tariff-free trade with other signators of the General Agreement on Tariffs and Trade is almost a fact. Tariffs are coming down to the point at which they will no longer provide serious protection to Canadian companies serving the domestic market. In two more years, they will reach a level that will encourage a flood of imports unless Canadian firms can defend their market positions by becoming fully competitive. Productivity differences and exchange rates are now far more important than duties. The issue for Canadian business is how to cope with this new environment.

Canadian companies will have to be world class to compete in their home market. Firms in most industries, must become internationally competitive to survive. All the major industrialized nations now have ready access to the Canadian market. All will find it increasingly easier to reach Canadian markets with their products and services, so Canadian companies will find themselves competing here with very

Mr Cartwright is immediate past chairman and chief executive officer of Canadian General Electric and chairman of International Trade and Industrial Task Force of the Business Council on National Issues.

strong foreign manufacturers for whom the Canadian market is only an incremental adjunct to their own huge domestic markets. In the absence of trade barriers to keep these competitors out of Canadian markets, we shall have to match them in product quality, efficiency, and costs. And this we can do only by matching their economies of scale, manufacturing our products in large volumes, and reaching beyond Canada to sell in world markets.

In the past, our manufacturing industries have, however, been geared to serve the relatively small domestic market. Hence many of our companies tend to be low-volume, high-cost producers. Canada is the only major industrialized country that lacks access to a market of 100 million people on a tariff-free basis. To the extent that Canadian companies depend upon trade barriers, they risk vulnerability. In the manufacturing industries, it is estimated that our costs, per unit of production average 20 per cent higher than our foreign competitors'. (Of course, there are a number of notable exceptions to this average.)

There are major opportunities for Canada in increased exports of manufactured products, provided we can achieve the economies of scale necessary for cost effectiveness and gain access to international markets.

Which markets? Let us consider each of them.

- Europe and Japan are protected by nontariff barriers. Europe is getting increasingly protective and represents a small, diminishing opportunity for Canadian exports. The 'third option' is an illusion based on wishful thinking. Japan, despite a stream of speeches proclaiming it will open its market to manufactured products and a token gesture now and then, shows no real evidence of abandoning its highly successful policy of improving its standard of living by adding value to imported raw materials and exporting finished products to the rest of the world, including Canada. It intends to keep the door closed to products with any significant Canadian labour content.

- Latin America presents a good opportunity for some Canadian sales of products that are cost-competitive, but it is not a big enough base nor sufficiently dependable a market to use as the foundation for major investment to achieve cost effectiveness. Its financial problems are well known.

- Southeast Asia (including China) probably represents the best long-term trading opportunity for Canada if we can demonstrate our competitiveness. Japan is far ahead of us there and at present is in a good position to block our entry for most products, but if we can match its costs in the next ten years, that part of the world holds great opportunity for us – eventually.

– This leaves the United States, a market ten times the size of Canada and plenty big enough to justify investment to achieve cost-competitive volume. This market is already vital to Canada. The numbers speak for themselves. About one-third of Canadian GNP is attributable to exports. In 1983, the United States received 73 per cent of all Canadian exports, including more than 80 per cent of our exports of manufactured products. One out of every five Canadian jobs depends on the United States market. And this situation is growing. When the final figures are in, we may find that exports to the United States made up as much as 78 per cent of our 1984 total. That would be an increase of five percentage points in a year. The annual incremental growth is twice that of our sales to Japan, our second largest trading partner.

Why change anything?

The news on trade with the United States is good news, so what's all the fuss about?

It's no secret that our cosy relationship with the United States is in serious danger and does not provide the ongoing confidence necessary for big Canadian investment to reach scale economies.

The United States is suffering the largest trade deficit in its history, partly because of the extraordinary rise in the exchange value of the US dollar and partly because of some of its industries' having lost their competitive edge. Many groups feel increasingly threatened by foreign competition and have been calling for – and getting – nontariff protection, such as import quotas and buy-American legislation at the state level. Forty-six states now have some form of protective legislation in place. In the US Congress, dominated by state and local interests, sixty-three bills presented in the last year contained clauses that would restrict Canadian exports to the United States. Most of these proposals were aimed at competition from Japan, Europe, or newly industrialized nations, but they did not specifically exclude application to Canada. Unless Canada does something to prevent it, we shall be caught in the middle of growing protectionist wars between the United States and other countries.

Fortunately, this attitude does not reflect the policy of the US federal government. The door is open for Canada to develop a bilateral relationship that could preserve and possibly enhance our access to the US market. The US government is willing to consider a bilateral deal with Canada for two reasons.

The first is that the United States wants a freer world trading system. The trends towards protectionism around the globe spell potential disaster for the economies of the free world. Some of us can remember or have taken the time to read what happened in the 1930s when protectionism exacerbated or possibly was the principal cause of a world depression that, in turn, led to the Second World War. Yet attempts to improve the world trading system are up against major obstacles in Europe and Japan. The United States sees a bilateral trade-improvement treaty with Canada as a good example that could influence other nations in the right direction.

The other reason is simple self-interest. It has been estimated that relatively free trade between the United States and Canada would raise the GNP (and hence the per capita income) of Canada about 10 per cent and that of the United States about 1 per cent. Neither figure is insignificant.

Why not grasp the opportunity?

With such obvious advantages, why should Canadians be reluctant to go after a deal that would sew up the US market? What causes Canadian fears?

Probably the most frequently voiced fear is loss of political sovereignty. Laurier's Liberals lost power in 1911 when Beauchamp Clark scared the pants off Canadians by suggesting that the free trade then being considered would lead to a US political takeover. That was seventy-four years ago, long before Canada attained its industrial maturity. Nevertheless, the fear has lingered up to today, when free trade is virtually a fact and the issue is how to protect the access we have to the US market.

Another expressed fear about closer ties with the United States is loss of Canadian cultural identity. What has trade to do with culture? Apparently trade barriers are insufficient to block world trends to rock-and-roll or blue jeans. One trip to Japan will convince you of this.

Yet another fear is of more open competition with US companies on the grounds that Canadian business managers may be inferior. A York University survey, reported in the 30 April 1984 *Financial Times* (Estabrook 1984) indicates that many people believe that Canadian managers don't have the youth, vitality, and education to go up against American managers.

What about Canadian confidence? Are we really little more than 'hewers of wood'? Despite the scale disadvantages of many Canadian industries, it is a fact that manufactured products have been our fastest growing export since the mid-1970s. Some companies have been restructuring and specializing and are fully cost-competitive. These firms do sell in the US markets and are not pushed around by theoretically superior American competitors.

Most of the larger affiliates of US corporations in Canada have chosen the world-product-mandate route, expanding their operations to world scale for some products and diverting investment away from others. This process was the subject of a provincial task force report a few years ago (Ontario Ministry of Industry and Tourism 1980). The strategy has been highly successful, and Canadian affiliates now have significant shares in a wide variety of US markets, impeded only by the nontariff barriers being erected by US politicians. This successful assault on American markets is by no means confined to US subsidiaries. Canada has such strong competitive positions in steel, aluminum, and petrochemicals – all basic industries – that they have triggered important protectionist efforts in the United States.

Other companies, showing ingenuity and management skills, export major portions of their production to the United States. Let me cite only one: CAE Industries Limited, which dominates the very high-tech flight-simulator field. There's nothing inferior about that Canadian management.

Beyond these examples, it is the expressed view of most Canadian businesspeople that Canada can become internationally competitive. I have discussed this at great length with large numbers of them; perhaps symptomatic of their attitudes is the fact that all the major Canadian business associations, including the Canadian Manufacturers' Association, the Canadian Chamber of Commerce, and the Business Council on National Issues, have published endorsements of trade negotiations with the United States.

Almost the only voices of real concern are in a few industries (for example, beer) that are now forced into uneconomic scale by provincial regulation. But this is a political matter, not a worry that Canadians don't have what it takes.

If I haven't already convinced you, let me draw on some help from three well-known businessmen.[1]

D'Arcy McKeough, in listing critical issues for Canada, says:

> On my list is expansion of trade with the US. The greatest opportunity for quick growth in national trade is undoubtedly in the US, the friendliest, most receptive, and best understood market available to us. Fortunately, the paranoia that has gripped some people at the thought of closer trading relationships with the US seems to be subsiding.

Peter Gordon of Stelco notes:

> The US situation gives an added sense of urgency to the Canada/US discussions on the possibility of a series of sectoral agreements or a more broadly based bilateral agreement.

David Culver of Alcan explains:

> To be successful in markets, both domestic and export, requires a level of cost competitiveness which can come only from specialization. Put very simply, an effective trade policy which encourages these Canadian winners is one that, by establishing and maintaining appropriate trade relationships, will give them secure access to large markets and thus the volume they need to specialize.

He encourages the direction being taken to gain wider access to the US market.

These are representative of the views of most Canadian business people, who have more confidence in their own ability than do the academics.

Bilateral or multilateral?

There is also the question of whether Canada should aim for a bilateral agreement or press for further multilateral agreements. In my view, there is no inconsistency in going for both. Our objective is to open up markets for Canadian products and services. We should most certainly continue to press for another improvement in the General Agreement on Tariffs and Trade and also offer any deal we make with the United States to other industrialized nations on the same terms.

In the recent government paper, *How to Secure and Enhance Canadian Access to Export Markets* (Kelleher 1984), an invitation is extended to discuss the desirability of and also the approach to a new agreement with the United States. The paper presents three alternatives:

– Do nothing. In my view, this is a formula for disaster. Canada must achieve international competitiveness to compete in the home market, and doing so requires access to the US market.

– Continue efforts towards sectoral agreements or, as a close alternative, take a functional approach. In my opinion, this has very little likelihood of success, and its pursuit could cost valuable time.

The authors of the sectoral approach had good intentions but failed to realize the breadth of understanding and support among businesspeople for agreement that would assure access to the US market. A sectoral approach provides too narrow a range for a successful negotiation. It would be too much of a rifle-shot, too confined. The trade-offs would be made too early, while dealing with easy sectors, and as negotiation expanded to other sectors, the Canadian negotiators' hands would be tied by previous piecemeal deals.

In addition, if sectoral agreements were made, they would attract special-interest groups in Congress to fight them. Consequently, the arrangements might have to be limited to executive agreements, instead of a trade treaty. Only the latter would override the protectionist state laws.

The clincher is the fact that sectoral agreements would require approval by two-thirds of the GATT nations under section 25 of the agreement. There is almost no chance of gaining such approval. But a more comprehensive bilateral agreement involving 'substantially all' trade between the two countries could gain automatic approval under section 24.

Fortunately, 'substantially all' means 80 per cent, so there would be an opportunity for some industries to opt out. In some industries, such as a number of food and beverage businesses, provincial and state regulations are so complex that it might take years to unravel them. This situation should not be allowed to hold up an agreement that would benefit other industries.

– Negotiate a comprehensive trade agreement with the United States. I agree with the Canadian Chamber of Commerce and the Canadian Manufacturers' Association that this is the best course for Canada.

The Business Council on National Issues has attempted to go one step further by suggesting a comprehensive framework agreement that could lead to negotiation. It was my pleasure to serve as chairman of the group's Task Force on International Trade and Industrial Development when its position paper was published (BCNI 1984).

This framework, which is intended as a mechanism, not an end, may have been the basis for the action taken by Prime Minister Mulroney in his recent meeting with President Reagan in Quebec. The paper proposes that the two nations agree to discuss an across-the-board deal that would fall under section 24 of the GATT, that would include services, that would focus on all nontariff barriers, and that would specify that we are not talking about a customs union, a common market, or any change in economic or political sovereignty.

I believe that the prime minister and the president took a very important step forward in Quebec City, moving in a direction that can bring great benefits to Canada and Canadians.

NOTE

1 The three quotations used here are from recent speeches and/or public statements. Unfortunately, I have misplaced my file of clippings and am unable to give citations.

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Discussion

CLIFFORD PILKEY (Ontario Federation of Labour): Alton Cartwright said that we should negotiate a free-trade position with the United States. Well, I've had a little experience with negotiations, and I feel very comfortable negotiating with somebody whom I feel I am on a par with. But I tell you, my friends, if I were negotiating with the Americans, I would not feel comfortable because all the cards are in their hands, not mine. There would be only one winner, and it wouldn't be us.

SYLVIA OSTRY (External Affairs): I'm not sure we have an option that amounts to 'stop the world I want to get off'. The situation is moving, inexorably moving, and therefore there has to be some kind of policy response, even from a small player.

JOHN CRISPO (University of Toronto): If we have no negotiating power vis-à-vis the United States, how were we able to negotiate the Auto Pact, which has given us more than any other single treaty we've ever negotiated? The benefits are unbelievable. It's responsible for more than half of our current-account surplus with that country.

CLIFF PILKEY: It has been beneficial up to a point, but don't say it's the best thing that ever came by. Only in recent times have we had a trade surplus from the Auto Pact. The United States kicked the heck out of us for a lot of years under that pact.

SIMON REISMAN (Reisman and Grandy Limited): It's terribly disappointing to find that our labour people are so despondent about Canadians' ability to negotiate, to compete, to look after their position in the world. I've negotiated with the United States in eight different sets of trade and tariff agreements since 1946, and I simply deny Cliff Pilkey's observations about what happens when Canadians sit at the table with Americans. If we know what we're up to and have the right people at the table, we can hold our own with anybody.

As for the Auto Pact, looking at the whole sequence since 1964, there's probably no single commercial-policy achievement that compares to it in scope, size, effectiveness, and impact on our productivity and on the well-being of all Canadians, particularly Canadian labour. It is very close to a free-trade arrangement. And the productivity it's helped us achieve in the automotive sector is world class.

PART II: THE VIEW FROM THE REGIONS

Canadian trade options from a regional perspective

James McNiven

The question of the nature of our trading relationship with the United States has bedevilled the politics of Canada since before the creation of either country. Over three centuries, conflicts over trading relationships between peoples in North America first flared into wars and later subsided into policy initiatives that can best be described as pushes and shoves. There is a certain linearity from the sacking of St. John's in the 1690s to the Shamrock Summit of last month, and it is at least as much a political linearity as an economic one.

My discussion of this trading relationship will also be more political than economic. I have read, or tried to read, much of the economic literature on the subject. Most of it is by Canadians who are concerned about the benefits or costs of free trade with the United States. A small amount of work comes from American scholars located in the northern border states, where awareness of these trade issues is most likely to exist. Even these analysts focus on the Canadian dilemma. If there is an American dilemma, the Americans on the whole seem unaware of its existence. American discussions of trade policy are focused almost exclusively on Japan or the problem of technological exports to the Soviet Union.

It would be wise to recall that the soul-searching that preceded the European common market was shared by citizens of a number of countries. Like Charlie Brown considering the red-headed girl, we may be in danger of spending a lot of time anguishing over a one-sided love affair.

Dr McNiven is deputy minister of the Nova Scotia Department of Development.

As far as I can tell, the economists who consider the free-trade scenario break down into two schools, which largely agree on the facts and assumptions but disagree on their implications. One side focuses on the problems of industrial adjustment and migration that would affect a good part of Canada's manufacturing industry. Allied to this school are the nationalists, who fear the erosion or even the end of Canadian sovereignty. The other side feels the adjustment, economic and cultural, is likely to be neither extreme nor to our overall disadvantage. These analysts emphasize the benefits to be gained by Canadians, especially consumers.

This argument could be couched as one between consumers and producers in Canada, with the nationalists lining up with the producers and their opposition with the consumers. It is, of course, more complicated than that. The 'producers' do not include most of those who produce for export. Instead, this group comprises producers who sell to Canadians largely behind tariff or other walls. Export producers generally do not oppose free trade, though there are exceptions (such as the protected brewing industry).

Likewise, the 'consumers' are not what they seem. Those who must consume Canadian goods and services because of tariff and nontariff barriers but gain little out of the exchange are most vociferous about the need for free trade. They include representatives of the Eastern and Western regions of the country, neither of which shares to any great extent the benefits of protection; in most cases, both suffer as actual consumers or as exporters who encounter American restrictions on their products. Consumers in central Canada would like cheaper goods, but to a great extent, they also like being employed. Adjustments under a transition to free trade might benefit them en masse, as some economists assert, but the individual uncertainties are quite disconcerting.

It is doubtful whether the arguments of the economists or the nationalists will really matter all that much as we move into the twenty-first century. They might if we were living in a static world in which no discernible trading trends existed and a choice over whether to move closer to the United States were a true choice. But that is not the situation at all.

The most graphic way I can illustrate what I am talking about is to tell a brief story. In February, I attended the First Ministers' Conference on the Economy in Regina as part of the Nova Scotia delegation. Being a bit parochial, like most of my colleagues, my mind wandered as I listened to a presentation from another province. The federal people had passed out a colourful little booklet on trade, and I noticed a chart in it that showed the trend line of Canadian exports to the United States as a percentage of our overall exports. Doodling, I extended the trend line until it was at 100 per cent and then roughly figured out the year that we could expect this event to happen. On the basis of our performance since the Second World War, the date I came up with was the year 2024. (The doodle is shown in Figure 1.)

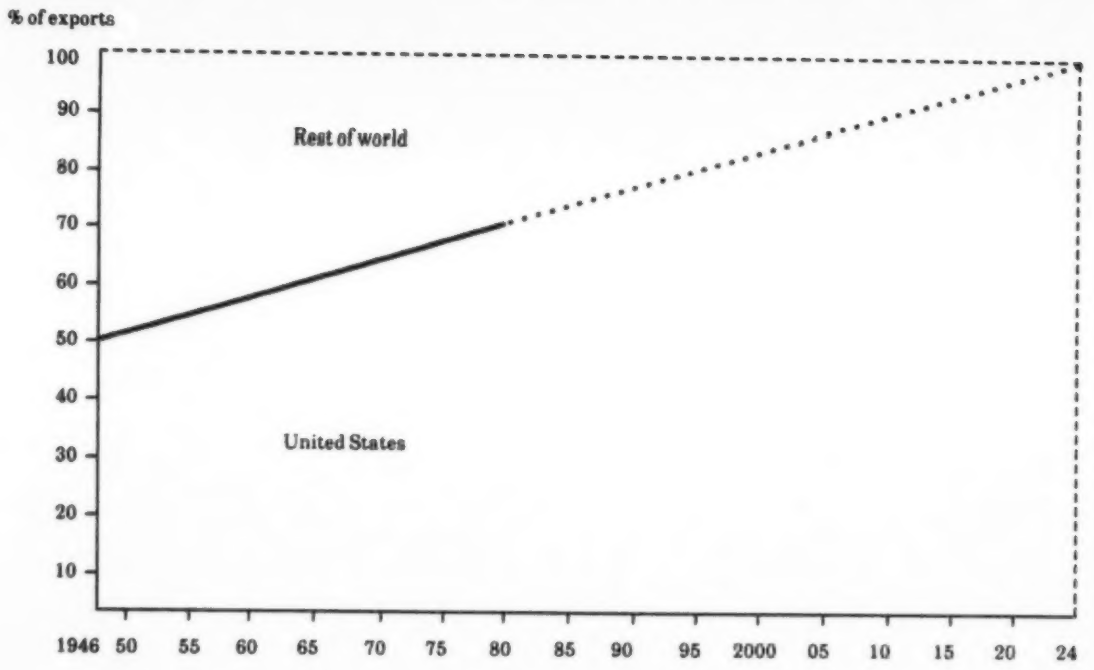
I have shown this chart to a lot of people, and the most sophisticated responses I have so far received are: (1) the outcome is impossible since it would mean we would be selling all our wheat to the United States; and (2) my little extension of the line is not mathematically sound since I did not develop it using proper formulae or tools. I do not doubt that the condition, like reaching absolute zero temperature, is probably an impossible one. Neither do I dispute that a proper calculation of the line might come up with the date 2020 or 2030. But so what?

The point is that in our present dynamic world, this is where we are going as long as we do nothing more than we have done in the past forty years. I don't think this is an ideological, political, nationalist, or antinationalist statement – it is simply an extension of a trend line that Ottawa was kind enough to provide me in an idle moment.

Back in Regina, that bit of doodling woke me up a bit. What really got me thinking was the chart shown in Figure 2, taken in conjunction with the trend line. Essentially, the chart says the same thing, except that it is a photograph of the trend line at a given point in time. As you can see, the United States is by far Canada's leading trading partner, so much so that Japan, the number two partner, is a very, very distant second.

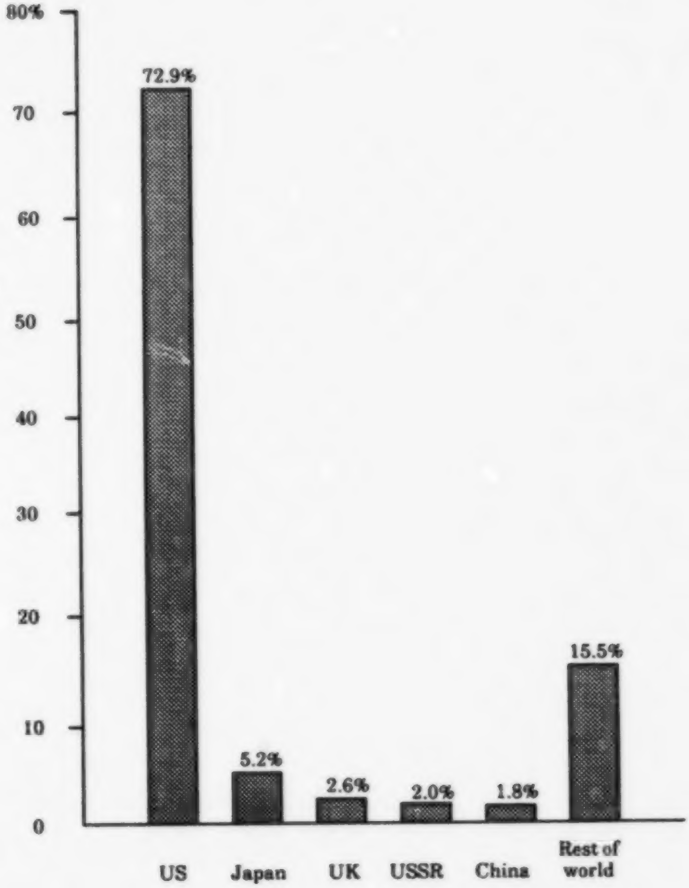
I have been a deputy minister long enough to have run into the proverbial problem of retailer monopsony – most or all of the production of a small manufacturer goes to a single retailer, such as a department store chain or a supermarket chain. Often, the producer finds that subsequent contracts are much, much tougher in terms of price and quality than was the original deal. The monopsonist exercises its market power, and the producer starts to wonder if it was really all that good a deal in the first place. Of course, by now it is trapped.

FIGURE 1
Trend line of Canadian exports to United States and rest of world



SOURCE: Through 1983, Canada (1985, 4). The 'projection' is my extension of the trend line.

FIGURE 2
Canada's five largest export markets, 1983



SOURCE: Adapted from Canada (1985, 3).

I do not know the point at which monopsony power can be effectively utilized in international relations. Maybe it is under the 76-per-cent level, where we are today. Maybe the 22 or 23 per cent of the United States' trade that is done with Canada is an offsetting factor. Maybe the notion that most of the time we are nice neighbours counts for something (though I suspect that business is business). However, I do know that some time as we leave today and approach 2024, we are going to find ourselves between the proverbial rock and hard place.

ALTERNATIVE COURSES

Since 2024 is probably twelve elections off, our situation probably isn't a big political worry yet. However, while we still pretend to have the vestiges of sovereignty, it might be wise to review our options. Later, the possibility of real choice will probably not be available.

There appear to be four courses of action we might take as a country.

Drift

A few years ago, Gilles Paquet spoke at a Conference Board in Canada session on the issues of the early 1980s. He was rather pessimistic, noting:

> One is left with a sense of drifting, with a sense that the balkanized and dependent Canadian socio-economy will not find a way to provide itself with the . . . mechanisms necessary to effect its transportation without a long period of chicanery and cantankerousness. (1980, 80)

Drifting along the trend line I described above is the most probable reaction to the issue. It is in the interest of much of the country, especially Central Canada, to do just that. A majority of Ontario's exports to the United States are covered under the provisions of the Auto Pact, while much of the rest of its manufacturing sector, the part that does not export a great deal, is protected by Canadian tariffs and other barriers. There is no particular reason why it should want to have to adapt to a new relationship with the United States, short of a collapse in the North American auto industry.

Quebec is a bit different. Today, as in the past, it stands to be forced into a lot of adaptation in the case of some new relationship with the United States. Yet international forces and the reluctance of even Ontario consumers to bear the burden of protecting the textile and shoe industries of a neighbouring province are forcing adaptation along anyway. The result is a growing ambiguity in Quebec over whether to adhere to the Ontario strategy or to co-operate with the free-trade orientation of the East and the West.

Even in Ontario itself, the strategy of drift can survive only as long as the manufacturing economy of the US 'rust belt' maintains itself. If the North American auto industry is forced to adjust to new realities in the next decade or two, then Ontario, too, will have to look for new solutions. The only question then will be whether it is too late to make a good deal.

Deal

The Western and the Atlantic provinces have been vociferous in their quest for some kind of trading agreement with the United States. To some degree, this attitude is based on sentiment as well as practicality. Both East and West have historical grievances against the protectionist National Policy that left them defenceless against Central Canadian manufacturing interests

In the East, the destruction of local industries before and after the First World War is still remembered. The West has always felt it never had a chance to develop such industries, let alone have them fall prey to Ontario and Quebec later on.

Further, both areas feel that the lack of a comprehensive free-trade agreement forces their economies into modes of production that fit the needs of US manufacturers. Raw materials are favoured as exports, not because Eastern or Western processors might not be competitive export manufacturers but because the lack of a free-trade agreement denies them the opportunity to compete. The future of the periphery of the country is forfeited to preserve the past in Central Canada by continuing to drift, avoiding a comprehensive trade agreement.

The East and the West also view sectoral agreements with suspicion, if only because the only large and successful one has been in the automotive industry, enhancing an existing two-way trade. In other areas, sectors might have to be linked together in order to derive a mutual benefit. Nova Scotians and Albertans fear that a deal might trade opportunities in the fish industry for those in petrochemicals, or vice versa, rather than include industries that are declining in Central Canada.

Another argument in favour of an agreement does not receive a lot of attention. This is the growth of north-south trade by regions. Research I have been involved with in Atlantic Canada, Quebec, and New England (Proulx and Shipman forthcoming) suggests that such a pattern is growing, relative to east-west trade. The centralized, Ontario-based distribution system for imported and domestically produced consumer goods masks this phenomenon to some extent nationally.

Since the regions are drifting apart anyway, the argument runs, why not get the best deal we can with our American partners while we still have some bargaining room. Once the American monopsony becomes self-evident to all concerned, we will be forced to settle for what we can get. At that point, the United States will have little reason to want to change the status quo, since it can use Canada as a reserve economy to absorb some of its cyclical problems.

Depend on friends

A variant on the drift strategy insists we can rely on the enlightened self-interest of our partners in the General Agreement on Tariffs and Trade to keep the game honest, even if we do trade almost exclusively with the United States. To some extent, this may be true. However, since we will do so little trade, relatively speaking, with our GATT partners in the future, it is doubtful that they would rush to our defence were the Americans to take up bending the rules against us. Historically, few scenarios in which threats were close at hand and allies were distant and distracted have ended well for those threatened.

Demonopsonize

The notion that Canadians ought to try to reverse the trend line and increase the proportions of our trade with other partners has never really been given much credence in the postwar world. Occasionally, British Columbia and Nova Scotia because of their locations on the oceans, suggest it as an alternative. But by and large, Canada thinks 'inland' and, in spite of its extensive coastline, has little interest in sea trade.

The language controversies of the past generation have also discouraged Canadians from learning foreign languages and thus opening more trade opportunities with more countries. Even the nationalists, who so greatly fear the ever-closer relationship with the United States, seem to shrink from advocating or acting to try to develop this alternative seriously. The so-called third option of the 1970s was a bad joke and should not even be brought up in this context. The present excitement about the Pacific Rim, although encouraging, must be kept in perspective. In total, our Pacific exports constitute only about 10 per cent of our total trade at best.

Yet attempting to end the American monopsony would be the only practical, long-term way of ensuring any form of Canadian economic sovereignty. It would be difficult and probably expensive to undertake. It would take a measure of 'national will' that Gilles Paquet doubts exists. I tend to agree with him.

CONCLUSION

In the end, since our GATT partners seem unlikely to be much help, there are three resolutions to our problem. If we drift, sometime before 2024 we will find that we have achieved the worst of all worlds. We will be dependent on our US buyers without any real say in the relationship between our countries, except that which our GATT friends might keep alive. Even the Commonwealth of Puerto Rico and the Micronesian Island Protectorate have better deals than that.

Second, we can try to break the monopsony before it breaks us. This would entail a national determination that is seldom seen outside of wartime. So far, no one seems prepared to look seriously at this alternative.

Finally, we can move now – or soon – to get the best deal we can. A bilateral treaty agreement would give the best guarantee we can hope for of Canada's rights in a close trading relationship. It is, ironically enough, probably the best guarantee of Canadian independence that we can obtain practically, if one assumes that trade and sovereignty have some kind of integral relationship. A policy of continued drift along the trend line, even one salted with the tough words of our nationalists, will lead only to a kind of hollow country.

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A Quebec perspective on Canadian trade options

Rodrigue Tremblay

INTRODUCTION

The establishment of a North American free trade area (NAFTA), which would give Canadian and US producers secured and preferential access to each other's market while each country retained its own trade barriers towards third countries, would require a basic industrial reorganization in the smaller economy, Canada. Over time, such an industrial reorganization would affect the economic structure of each main Canadian region differently. Essentially, Canadian regions with a protected, import-competing industrial structure would experience either a shift within each industry towards more specialization and higher scales of production or a shift among industries in favour of the least protected ones and against the most protected ones.

Therefore, it has to be recognized at the outset that the industrial regional impact of a NAFTA would be substantial in Canada. On this score, three observations are warranted.

1 The Canadian regional economies would have to undergo more numerous and profound industrial adjustments in output structure and in employment-mix than regions in the United States. US firms have production installations that are already geared to a large market, while many Canadian producers would have to adapt to new markets.

Professor Tremblay is a member of the Departement de sciences économiques, Université de Montréal.

The author wishes to express thanks to Sylvain Gareau for technical assistance.

2 Since import-competing firms are more concentrated in the manufacturing sector than in other sectors, the more manufacturing industries a region or a province has, the more opportunities the secured access to new markets would create, but also the more reorganization it would have to go through. If trade liberalization were extended to the service sector through the dismantlement of nontariff barriers, regions with a large tradable services sector would also be much affected.

3 The industries in which the need of reorganization would be the strongest and for which the risks of industrial disruptions would be the highest in terms of plant closures and structural unemployment would be those that are the most remote from the regional resource base. Footloose industries in both the manufacturing and the tradable services sector could experience adjustments and reorganizations within a region, be subjected to an interregional displacement of economic activity, or both.

For these reasons, it should be expected that the major part of industrial adjustments to a NAFTA would be concentrated in Ontario and Quebec, which have the highest concentration of footloose manufacturing and service industries.

FREE TRADE AND TRADITIONAL THEORY

If we rely on simple, traditional Ricardian or Heckscher-Ohlin trade models, we expect the establishment of a NAFTA to push the Canadian industrial structure towards resource industries with a relative contraction of the manufacturing sector and possibly the contraction of the tradable services sector. Canada already has a comparative advantage in resource-related products. Free trade would accentuate this specialization. Canadian consumers would gain by such a move, and the Western provinces and the Maritimes would see their resource sectors and resource-related industries expand with more exports. Resource owners would gain and, these industries being capital-intensive compared to other domestic industries, so would capital owners. The losers would be Quebec and Ontario, which would witness a contraction of their manufacturing sectors against American imports. The workers in general would also be losers, especially in labour-intensive industries. Wages would fall to reflect the common North American set of commodity prices, unless labour productivity were to increase. Indeed, according to the Stolper-Samuelson theorem, a relative decline in the price of a commodity will decrease the relative return to the factor used intensively in that industry and will increase the real return of the other factor. North American free trade within the traditional framework would be especially bad news for immobile workers in Quebec and in Ontario and for labour generally and good news to resource owners in the West and in the Maritimes and to owners of mobile capital everywhere. Because a NAFTA would mean less east-west trade and more north-south trade, transport costs would be lowered, which would doubly benefit consumers.

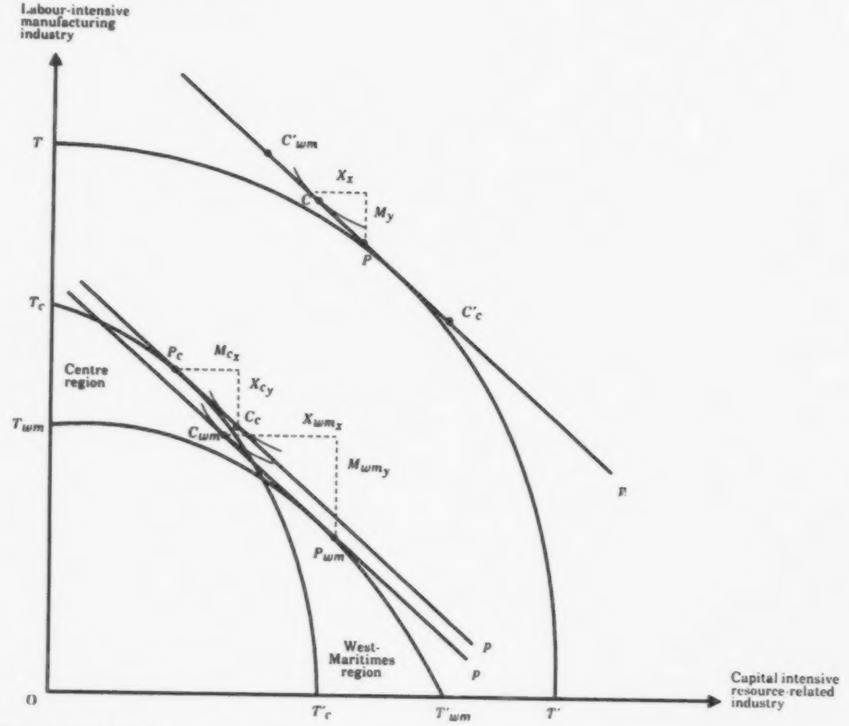
A two-region trade model

This result can be readily seen in a figure adapted from James R. Melvin (1983) to show how international trade can be a substitute for interregional trade and what happens when interregional transport costs are higher than international ones. The traditional theory of international trade supposes that all production takes place in a single location with factors perfectly mobile to that location. In a two-region trade model, however, this hypothesis must be modified and transport costs introduced. If transport costs between regions are high while they are nil between each region and the international market, it is possible for each region to specialize in a single commodity and for the country as a whole to import *and* export internationally both commodities. In Canada, this is the case for oil, which is exported by the Western provinces and imported by the Eastern provinces, while cars are exported by the Eastern provinces and imported by the Western provinces.

Figure 1 illustrates the situation in which two regions, the Centre region, *c*, and the West-Maritimes region, *wm*, are separated by high transport costs, have identical consumer preferences, and differ in terms of factor endowments. It is assumed the Centre region is labour abundant and specializes in the labour-intensive manufacturing industry *y*, while the West-Maritimes region is resources abundant and specializes in the capital-intensive resources-related industry *x*.

In the diagram, *M* and *X* indicate importation and exportation respectively. With free trade, the world price ratio *p* meets the transformation curve of the entire economy, *TT'*, and those of the two

FIGURE 1
Free trade and regional specialization


Labour-intensive manufacturing industry
Capital intensive resource-related industry
T
T_c
T_{wm}
O
T'_c
T'_{wm}
T'
C'_{wm}
X_x
C
M_y
P
C'_c
p
P_c
M_{c_x}
X_{c_y}
C_c
C_{wm}
X_{wm_x}
M_{wm_y}
P_{wm}
p
p
Centre region
West-Maritimes region

SOURCE Melvin (1983)

regions, $T_cT'_c$ and $T_{wm}T'_{wm}$. Production is at P for the entire economy but at P_c and P_{wm} for each region. The consumption point is at C for the economy as a whole and breaks up between regions at C_c and C_{wm}. Because of transportation costs, there is intranational trade *and* international trade. For this reason, gross trade is larger than net international trade. The Centre region imports x and exports y, while the West-Maritimes region imports y and exports x. For the country as a whole, the net trade shows exports of x and imports of y. However, the trade vector for total trade is not CP but $C'_{wm}C'_c$ where $PC'_{wm} = C_{wm}P_{wm}$ and $PC'_c = P_cC_c$.

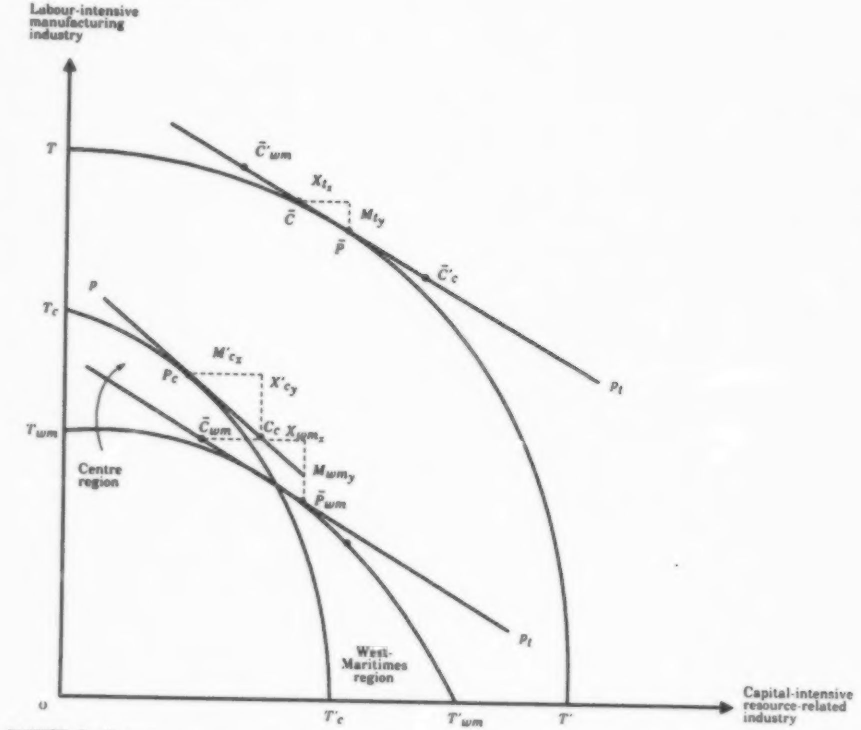
The regional-welfare and production effects of a tariff on the importation of y, the labour-intensive manufacturing good, can be seen in Figure 2. The domestic price ratio, p_t, is less steep than the world price ratio p. The higher relative price of y increases its production in the region that imports this commodity at P_{wm} and has no impact in the region that exports it. Consumption levels and welfare remain the same in the Centre at C_c but fall in the West-Maritimes region at C_{wm}.

With the tariff and interregional transport costs, however, prices are no longer identical. Therefore, following the Stolper-Samuelson theorem, factor prices must change. In the West-Maritimes region, the price and output of y rise while the price and output of x fall. Because y is labour-intensive, real wages increase; because x is resource- (and capital-) intensive, resource rents and real returns to capital decline. If the extreme assumption of no transport costs internationally and very high transport costs between the regions were relaxed and, above all, if the Centre region were also importing y, the output of y and its price would then increase in the Centre region; in which case, real wages would also rise in the Centre.

Problems with traditional theory

According to the traditional theory of international trade, therefore, the removal of tariffs at the Canada/US border would lower real wages and increase real rents and real returns to mobile capital. In a few words, Canadians could become 'hewers of wood and drawers of water'. These results would reflect W.A. Mackintosh's (1924) and H.A. Innis's (1927) 'staple thesis' of Canadian export-led growth dictated by foreign demand and concentrated on products with high natural-resource content.

FIGURE 2
Tariffs and regional specialisation



SOURCE: See Figure 1.

For these traditional results to hold, however, four crucial assumptions are required. First, the factors of production must be mobile interregionally but not internationally; second, firms and industries must operate with constant returns to scale; third, firms must be competitive; and finally, the economy must operate at full employment. Of course, capital and entrepreneurship are very mobile in and out of Canada. Similarly, for many industries and firms in the manufacturing sector, efficiency levels of output require large-scale production; as a consequence, Canadian firms are smaller than their American competitors, and they tend to produce a wider range of products. Economies of sale (decreasing costs) could, therefore, be reaped in many Canadian industries through specialization and exports. Moreover, in many industries, the de facto market structure involves imperfect competition and differentiated products, not the competitive situation assumed by the factors-proportions theory.

Because of these features of the Canadian economy compared to the international economy and especially the US economy, many trade models consider the US tariff brings more harm to Canadian welfare than any benefit that the Canadian tariff can provide.

On the one hand, the factual studies by Eastman and Stykolt (1967) and Baldwin and Gorecki (1983b) document that Canadian plants are smaller on average than US plants, especially in the high-tariff, high concentration industries. On the other hand, industrial-organization analyses by Wonnacott and Wonnacott (1967), Williams (1976), Pinchin ([1970] 1974), Cox and Harris (1983), and Harris (1983) conclude that neither free trade with the United States nor multilateral trade liberalization would result in a contraction of the Canadian manufacturing sector, even though Quebec and Ontario would be the provinces in which the consequent industrial reorganization would have to take place.

On the level of regional and factor rewards, what these analyses say is that the domestic- and foreign-tariff cost supported by Canadian consumers coast to coast through higher prices does not accrue to workers or capital owners in the manufacturing sector but is wasted in inefficient scales of production and in unnecessary interregional transport costs. Everybody loses with the tariff except, when imports still enter, the treasury and possibly the immobile factors of production in competitive, labour-intensive, final-goods industries, some of which (leather, knitting mills, clothing, and so on) are heavily concentrated in Quebec.

More fundamentally, however, what these analyses say is that orthodox trade theory is inadequate to predict the end results of a liberalization process. Most of the adjustment to trade liberalization would be intraindustry and not interindustry as the Heckscher-Ohlin view of comparative advantage predicts. When one takes account of the industrial reorganization that would take place within each industry after a move towards trade liberalization, efficiency (comparative advantage) increases, factor rewards increase, and output increases. For such adjustment to occur within each industry, the number of firms must decline, plant size must increase if economies of scale are present, and the number of product lines must be reduced in order to allow specialization within each plant. When these intraindustry and intrafirm adjustments are realized, the welfare gains from trade liberalization for a small, open economy such as Canada's are not 1 or 2 per cent of GNP but 8 or 12 per cent of GNP (Harris 1983).

The cost of protection and the gains to be had from trade liberalization are fairly large for a small, open economy when the analysis drops the assumptions of competitive constant returns of traditional theory.

FREE TRADE AND INDUSTRY: TWO SCENARIOS

The recent theoretical and empirical work in this line is the work by Harris (1983), Harris with Cox (1983), and Cox and Harris (1983), who concentrate on potential scale economies at the individual plant that derive from trade liberalization for Canada for imperfectly competitive firms.

Firms operating in an imperfectly competitive industry with increasing returns and with collusion can reap large gains from free access to external markets, while firms operating in a competitive industry at constant costs have less opportunity to lower costs and expand. Harris assumes that all twenty manufacturing industries in Canada are noncompetitive while the nine nonmanufacturing industries are competitive and face constant returns. In addition, Harris uses two crucial assumptions: (1) that Canadian manufacturing prices are a mixture of monopoly prices set according to the elasticity of demand (Negishi 1961) and a markup of world prices plus the tariff

(Eastman and Stykolt 1967); and (2) that there are no excess profits in Canadian industry (that is, it is in long-run equilibrium) because there is free entry with fixed costs being the only entry barriers. As a consequence, any tariff reduction lowers prices and forces rationalization. (Harris's results are very sensitive to the empirical significance of these assumptions and of other assumed parameters.) He uses one internationally fixed factor, labour, and one internationally mobile factor, capital services; both factors are mobile between firms and between industries.

Harris's static general-equilibrium model gives the percentages of output changes for multilateral free trade, as shown in Table 1. Notice the difference in results when he assumes all Canadian manufacturing industries have collusion, inefficiencies, and available economies of scale (first column) and when he assumes they are basically competitive and operate at constant costs (second column). In the first case, the output adjustments to trade liberalization are mainly intraindustry. In the second case, they are mainly interindustry as the neoclassical factors-proportion theory of comparative advantage predicts. It might, therefore, be wise to consider these two sets of results as two extreme scenarios, one optimistic and one pessimistic, for multilateral trade liberalization.

The predictions of output change for five out of the twenty manufacturing industries have different signs depending on whether one assumes perfect competition or imperfect competition. In the competitive model, nearly half (nine) of the manufacturing industries contract after free trade. In the collusion model, only four do so, none by more than 20 per cent. In both models, however, all nine of the resource-sector industries expand with multilateral free trade.

The regional impact of free trade

It is possible to isolate the regional output impact of free trade according to the optimistic and the pessimistic scenario. This is done by multiplying the percentages of output changes by the value of output for each industry and for each region.

Let us consider first the optimistic scenario (imperfect competition and increasing returns to scale). If we use the regional breakdown of Canadian production in 1976 (see Table 2) and Harris's output elasticities, it turns out, as expected, that the winning provinces are Ontario and Quebec (see Table 3). Overall manufacturing production

TABLE 1
Harris's percentage changes in output with multilateral trade liberalization

	Output changes assuming	
	Imperfect competition	Perfect competition
Food and beverage	0.2907	0.0077
Tobacco	0.3178	-0.0869
Rubber and plastic	0.4276	0.0480
Leather	-0.1314	-0.3848
Textiles	0.9417	0.5741
Knitting mills	0.0674	-0.3945
Clothing	0.6842	-0.2093
Wood	0.1180	0.0461
Furniture and fixtures	-0.1837	-0.2903
Paper and allied products	0.9578	0.9162
Printing and publication	0.3423	0.1900
Primary metals	0.3753	0.0709
Metal fabricating	0.2261	-0.1863
Machinery	-0.0703	-0.1863
Transportation equipment	1.2184	0.3727
Electrical products	0.0190	-0.1799
Nonmetallic mineral production	0.2521	0.0172
Petroleum and coal	0.2596	0.1820
Chemical products	0.2885	0.1265
Miscellaneous manufacturing	-0.1046	-0.2842
Agriculture	0.6063	0.5120
Forestry	0.3123	0.3592
Fishing	0.3214	0.2472
Mining	0.2846	0.2683
Construction	0.0404	0.0129
Transportation	0.0152	0.0249
Communication	0.0237	0.0106
Electric power and gas	0.1728	0.1033
Others	0.0623	0.0309

NOTE: Data is from 1976.
SOURCE: Harris and Cox 1983.

would increase by 48.2 per cent in Ontario and by 42.4 per cent in Quebec. It would also increase in all other Canadian regions: 40.5 per cent in British Columbia, 29.0 per cent in the Prairies, and 24.4 per cent in the Atlantic provinces. Since only four out of the twenty-nine manufacturing and nonmanufacturing industries would contract with multilateral free trade, none by more than 20 per cent, all the regional economies would gain production in this scenario. The more industrialized a region, the larger the gain, however. Ontario, being the

TABLE 2
Canadian manufacturing and resource-sector production, 1976 ($000s)

	Ontario	Quebec	Atlantic provinces	Prairies	BC
Food and beverage	$6,872,660	$4,714,948	$1,272,075	$3,132,580	$1,296,807
Tobacco	489,611	396,672	-	-	-
Rubber and plastic	1,479,677	539,502	-	-	-
Leather	367,133	283,554	-	35,170	-
Textiles	1,228,274	-	61,443	31,569	
Knitting mills	168,451	412,227	-	-	-
Clothing	555,433	1,721,373	-	-	58,918
Wood	734,319	953,638	221,454	445,078	2,642,945
Furniture and fixtures	743,036	532,419	23,786	115,625	52,801
Paper and allied products	2,459,739	2,603,846	-	-	1,855,671
Printing and publication	1,585,764	1,001,549	83,041	332,370	236,554
Primary metals	4,508,657	1,512,644	-	-	413,608
Metal fabricating	4,110,956	1,570,287	-	610,696	405,126
Machinery	2,572,528	612,816	22,455	481,216	196,030
Transportation equipment	10,310,687	1,574,774	-	423,274	364,937
Electrical products	3,173,341	1,196,632	62,548	179,551	121,031
Nonmetallic mineral production	1,354,928	702,152	108,742	472,356	203,139
Petroleum and coal	2,078,140	2,120,319	-	29,621	604,197
Chemical products	3,397,511	1,486,191	-	411,611	260,838
Miscellaneous manufacturing	1,455,280	520,734	27,253	72,131	50,441
Agriculture	2,827,347	1,363,213	341,180	4,984,577	477,225
Forestry	353,893	507,331	291,572	71,105	1,931,451
Fishing	24,323	34,682	419,219	-	244,572
Mining	2,348,120	1,272,775	1,002,049	7,862,512	1,413,215
Construction	9,796,492	7,477,294	2,586,015	7,315,202	4,273,856

SOURCE: Statistics Canada (Cat. 31-203; 31-204; 21-202; 25-202; 26-201; 32-216; 64-201).

TABLE 3
Simulated manufacturing production with multilateral free trade, imperfect competition and economies of scale, 1976 ($000s)

	Ontario	Quebec	Atlantic provinces	Prairies	BC
Food and beverage	$8,870,542	$6,085,583	$1,641,867	$4,043,221	$1,673,789
Tobacco	645,209	522,734	–	–	–
Rubber and plastic	2,112,387	770,193	–	–	69,143
Leather	318,892	246,295	–	30,549	–
Textiles	2,384,940	2,613,252	–	119,304	61,298
Knitting mills	179,805	440,011	–	–	–
Clothing	935,460	2,899,136	–	–	99,230
Wood	821,630	1,067,026	247,785	497,998	2,957,191
Furniture and fixtures	606,540	434,614	19,417	94,385	43,101
Paper and allied products	4,815,677	5,097,810	–	–	3,633,033
Printing and publication	2,128,571	1,344,379	111,466	446,073	317,526
Primary metals	6,200,756	2,080,339	–	–	568,835
Metal fabricating	5,040,443	1,925,329	–	748,774	496,725
Machinery	2,391,679	569,735	20,876	447,387	182,294
Transportation equipment	22,873,228	3,493,479	–	938,911	809,576
Electrical products	3,233,634	1,219,368	63,736	182,962	123,331
Nonmetallic mineral production	1,696,505	879,165	136,156	591,437	254,350
Petroleum and coal	2,617,625	2,670,754	–	37,311	761,047
Chemical products	4,377,693	1,914,957	–	530,361	336,090
Miscellaneous manufacturing	1,303,058	466,265	24,402	64,586	45,138
Increase in production	48.16%	42.39%	24.40%	28.97%	40.50%
New relative share in total	54.99	27.47	1.69	6.56	9.29
Net change in relative share	+1.56	–0.29	–0.27	–0.76	–0.22

SOURCE: My own calculations from data in Tables 1 and 2.

the most industrialized province, would gain the most. And it would be the only province to increase its relative share of manufacturing activity (by about 1.5 per cent).

If, however, the extent of collusion in price fixing in the Canadian manufacturing industries is less than assumed by Harris, there is less scope to increase welfare with unilateral free trade (evaluated by Harris at approximately 4 per cent of GNP). And if the presence of economies of scale is not widespread in all manufacturing industries, there are smaller rationalization gains from increased access to the US and other foreign markets. The results of assuming this pessimistic (competitive) scenario are shown in Table 4. With the percentages of output changes of the competitive model, there would be no welfare gain with unilateral free trade and the gain from multilateral free trade would be considerably reduced at 2.4 per cent (see Harris 1983). The impact on regional outputs would be much more pronounced since nine manufacturing industries out of twenty would contract, some (leather and knitting mills) by almost 40 per cent. The interindustry adjustment would still raise efficiency, but the output increases would be smaller than with collusion and economies of scale. Manufacturing activity would increase by 23.0 per cent in British Columbia, 12.18 per cent in Quebec, 11.28 per cent in Ontario, and marginally in the Prairies (by 0.93 per cent) and the Atlantic provinces (by 0.42 per cent). In relative terms, Ontario, the Prairies, and the Atlantic provinces would lose marginally to British Columbia and to a lesser extent to Quebec, whose relative shares of Canadian manufacturing activity would increase by approximately 1 per cent and 0.13 per cent respectively.

Therefore, if multilateral free trade did not bring about an industrial reorganization within each industry by lengthening production lines, increasing output per plant, and thereby reducing average costs, interindustry adjustment would still lead to specialization and efficiency gains. The output of more specialized Canadian manufacturing industry would increase by an average of 13 per cent, with the increase concentrated in British Columbia, Quebec, and Ontario. This is to be compared with an approximate increase of 44 per cent if multilateral free trade reduced collusion in Canadian manufacturing industry and generated economies of scale. All provinces would still gain after the long-run equilibrium had been reached, although the industrial gains would be small for the Prairies and the

TABLE 4
Simulated manufacturing production with multilateral free trade, perfect competition, and constant returns to scale, 1976 ($000s)

Industries	Ontario	Quebec	Atlantic provinces	Prairies	BC
Food and beverage	$6,925,579	$4,751,253	$1,281,870	$3,156,701	$1,306,792
Tobacco	447,064	362,201	-	-	-
Rubber and plastic	1,552,033	565,883	-	-	50,801
Leather	225,860	174,442	-	21,637	-
Textiles	1,933,426	2,118,515	-	96,717	49,692
Knitting mills	101,997	249,604	-	-	-
Clothing	439,190	1,361,090	-	-	46,586
Wood	768,171	997,601	231,663	465,596	2,764,785
Furniture and fixtures	527,333	377,858	16,881	82,059	37,473
Paper and allied products	4,713,352	4,989,490	-	-	3,555,837
Printing and publication	1,887,059	1,191,843	98,819	395,520	281,499
Primary metals	4,828,321	1,619,890	-	-	442,933
Metal fabricating	3,345,085	1,277,743	-	496,923	329,651
Machinery	2,093,266	498,648	18,272	391,566	159,510
Transportation equipment	14,153,480	2,161,692	-	581,028	500,949
Electrical products	2,602,457	981,358	51,296	147,250	99,258
Nonmetallic mineral products	1,378,233	714,229	110,612	480,481	206,633
Petroleum and coal	2,456,361	2,506,217	-	35,012	714,161
Chemical products	3,827,296	1,674,194	-	463,680	293,834
Miscellaneous manufacturing	1,041,689	372,741	19,508	51,631	36,084
Increase in production	11.28%	12.18%	0.42%	0.93%	23.00%
New relative share in total	53.24	27.89	1.76	6.61	10.48
Net change in relative share	–0.19	+0.13	–0.20	–0.71	+0.97

SOURCE: See Table 3.

Atlantic provinces. (Of course, the the residents of even the Atlantic provinces could benefit in terms of net welfare since consumer prices would decline. Welfare could increase if the deterioration in terms of trade was not too large [Boadway and Treddenick 1978].) Structural unemployment would most likely accompany such interindustry shifts from labour-intensive industries to capital and resource-intensive industries, and the short-run adjustment cost might neutralize much of the long-run welfare gain.

In a dynamic world, small regions, especially those that specialize in vulnerable industries, may face problems in keeping or attracting industries with economies of scale when tariff protection or production subsidies are removed. It is not inconceivable that small regions such as the Maritimes could become less industrialized with tariff removal.

Free trade and the resource sector

We have estimated the regional effects of free trade on the output of five resource industries. These industries are generally more competitive than the manufacturing industries; as a consequence, the output effects reported in Table 5 are all positive and do not vary substantially between the collusion and competition models.

The regional impact of free trade would go in a different direction, however, for resource industries than for manufacturing industries. The Prairies region would be the principal beneficiary of trade liberalization with an overall expansion of its resource industries of 27.6 per cent. Its agricultural production would expand the most, with an increase of 60.6 per cent or 52.1 per cent, depending on the model. British Columbia would benefit from an expansion of its forestry industry, while the Atlantic provinces would see their fishing and mining industries expand the most. The resource industries in Ontario and Quebec would also expand but by relatively less than those of the other regions.

THE IMPACT OF A NAFTA IN QUEBEC

Although the results of Tables 3 and 4 refer to multilateral free trade and not to Canada/US bilateral free trade, they nevertheless can be used to assess the likely impact of a NAFTA on the Quebec economy. For the manufacturing sector, they indicate that Quebec has a higher degree of vulnerability than Ontario to disrupting shocks.

TABLE 5
Simulated resource-industries production under multilateral free trade with imperfect competition and economies of scale and with perfect competition, 1976 ($000s)

	Ontario	Quebec	Atlantic provinces	Prairies	BC
Imperfect competition					
Agriculture	$ 4,541,567	$ 2,189,729	$ 548,037	$ 8,006,726	$ 766,566
Forestry	464,413	665,770	382,630	93,311	2,534,643
Fishing	32,140	45,828	553,956	-	323,177
Mining	3,016,395	1,635,006	1,287,232	10,100,183	1,815,415
Construction	10,192,270	7,779,376	2,690,490	7,690,490	4,446,519
Relative share in total	25.44%	17.17%	7.61%	35.99%	13.78%
Net change	-0.48	-0.83	-0.23	+1.82	-0.30
Perfect competition					
Agriculture	$ 4,300,394	$ 2,073,446	$ 518,934	$ 7,581,541	$ 725,859
Forestry	481,011	689,564	396,304	96,645	2,625,228
Fishing	30,335	43,255	522,849	-	305,030
Mining	2,978,120	1,614,260	1,270,898	9,972,023	1,792,380
Construction	9,922,866	7,573,751	2,619,374	7,409,568	4,328,988
Relative share in total	25.35%	17.16%	7.62%	35.86%	13.99%
Net change	-0.57	-0.84	-0.22	+1.69	-0.09

SOURCE: See Table 3.

First, there is Quebec's industrial structure. It has a relatively high proportion of footloose manufacturing industries, which may contract rather than reorganize (although less so with a NAFTA than with multilateral free trade). Quebec is especially well represented in the five industries that would tend to contract with free trade: the leather and the furniture industries and, but with less certainty, the clothing, the knitting mills, and the tobacco industries. Such industries are labour-intensive, and their contraction would be accompanied by short- and medium-term unemployment. Not surprisingly, these industries are also the ones for which Canadian tariffs are now the highest.

On the other hand, Quebec is well represented in two of the four industries most likely to expand with free trade: the paper products and the textile industries. Quebec would also participate, although less than Ontario, in the expansion of the transportation equipment and the rubber and plastic industries.

It can be argued that the Quebec manufacturing sector is relatively more vulnerable to exogenous shocks for several other reasons. The cyclical behaviour of employment in Quebec seems to be more volatile than in Ontario, with recessions being deeper and upturns slower in gaining back the lost ground (Swan 1972). This volatility may be related to Quebec's higher volatility of employment in the resource sector. On the whole, however, its manufacturing firms tend to resist economic adversity less well than Ontario's, perhaps because of their smaller size or their relative undercapitalization. Over the last thirty years, Quebec's share of Canadian manufacturing net investment has systematically trailed its share of manufacturing output.

Other factors of vulnerability may be tentatively advanced for Quebec. If a firm's operations in that province are less stable than its operations elsewhere, a branch-plant effect may show up in times of economic slack and weak demand. Another factor may be the economic and social environment created in Quebec by a relatively heavy tax burden and by labour laws and regulations that may either cause or reinforce any branch-plant effect.

CONCLUSIONS

If it is accepted that Ontario and Quebec are the two Canadian provinces that would experience the heaviest load of adjustments with free trade and if the Quebec economy appears to be the more vulnerable to dislocations in a transitional phase, this situation seems to call for special measures to accompany the implementing of a NAFTA.

We can identify at least four types of measures:

1 Because of the industrial adjustments that Canadian industry would have to undergo and because Canadian tariffs in 1987, after the Tokyo Round reductions, would still average twice as high as the US tariffs (9 to 10 per cent for Canada compared to 4 to 5 per cent for the United States), the time schedule for tariff elimination should reflect this objective situation. Such a time schedule might be five years for US industry and ten years for Canadian industry. For certain industries, special time schedules may also be needed.

2 Some safeguards for regional employment appear to be required. Indeed, there is a reasonable risk that certain regions would experience bouts of unemployment if the adjustments to trade proved more interindustry and interregional than intraindustry and intraregional. Some safeguards should, therefore, be established to trigger a stop or a postponement in the time schedule of trade barriers elimination if employment in a regionally concentrated industry contracts by more than a certain percentage within one year.

3 Compensation and assistance to trade-displaced workers seem equitable in policy-induced reorganizations, such as those that result from a comprehensive shift in trade policy. For example, Canada established the Transitional Assistance Benefits program (TAB) between 1965 and 1976 to alleviate auto workers' adjustment burdens that arose from the Canada/US Auto Pact of 1965. Three thousand workers benefited from TAB (Robertson and Grey 1984). Such a ten-year program would appear to be needed for the workers who would inevitably be displaced by a NAFTA.

4 It has to be recognized that the basic objective of trade liberalization would be to reorganize and strengthen Canadian industry through higher productivity by enlarging Canadian plants and by concentrating production runs. Many firms would have to invest in new installations or equipment; some would even have to merge with larger firms. Such new investments would be greatly encouraged by the establishment of an industrial trade reorganization fund by the federal government and by the provincial governments that are the most directly concerned. Such a fund would contribute to ensuring

that the new trade opportunities and the required industrial consolidation that would accompany the establishment of a North American Free Trade Area would not be passed by through inertia or lack of capital.

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An Ontario perspective on Canadian trade options

Carl E. Beigie and James K. Stewart

In preparing this paper, we have assumed that it calls for something more than the professional views on trade-policy options held by economists who happen to reside in Ontario. Our work, like that of many economists in this country, has focused on a broad Canadian perspective on trade. Yet regional perspectives are vital elements of federations and are thus important to the formation of national policies in Canada. Accordingly, we try to describe a representative Ontario perspective on Canadian trade-policy options and then consider how Ontario's particular adjustment needs might be reflected in the national decisions that are called for in this crossroads period.

THE ONTARIO VIEW ON TRADE

It would be inaccurate, in our judgement, to say that Ontario is pleased with its current situation. At the same time, however, we do not think it unfair to claim that it is not greatly dissatisfied with either its relative economic performance over the past two years or its long-standing political power to influence the course of policy developments in Ottawa.

On the economic front, the provincial rate of unemployment remains well above the desired level, but it is well below the national average and only slightly higher than the average across the United States. Growth has been relatively robust, and exports, especially to

Mr Beigie is director and chief economist and Mr Stewart is vice-president and economist of Dominion Securities Pitfield Limited, Toronto.

the United States, have been strong in volume and, especially important, in value. Meanwhile, inflationary pressures have remained quite moderate, and the provincial budgetary deficit has been nudging downwards.

On the political front, Ontario, a province with roughly one-third of the national population of voting age, knows that no federal government can afford to ignore its fears and desires. A change in the province's governing party might cause some disharmony with Ottawa, but the province's economic health is too dominant a factor in the overall national picture to be treated lightly.

It is against this backdrop that we view Ontario as approaching the issue of national trade-policy options in what can be described as the traditional Canadian way: the optimum strategy is to work the multilateral route, maximizing opportunities for export expansion (especially with the United States) but going extremely cautiously in any differentiated bilateral deal with the United States.

Although it is a gross oversimplification to speak of a provincial policy perspective as if it were shared by everyone living there, support is widespread in Ontario for the view that it is inappropriately extreme to claim that Canada is at a crossroads in trade policy. An alternative formulation that would find broad agreement in the province is that world trade is on a bumpy stretch in an otherwise well-constructed road that Canada should not depart from significantly.

Concerns about the bilateral approach

Although we believe that the perspective just described involves a certain degree of short-term, narrow, and even insular thinking about the Ontarian, North American, and world economic prospects, the archetypical provincial view reflects more complex concerns than mere smugness. Indeed, Ontario represents so large a fraction of the Canadian economy and, more important, is so diverse in what it does that it encompasses a wide range of perspectives on trade-policy options.

There is an awareness across the province of the potential gains to be realized from trade-liberalizing agreements. However, Ontarians tend to see these gains as less dramatic than 'free-traders' postulate and to regard them as being achievable largely through cautious increments. Moreover – and this is a very significant factor shaping the provincial perspective – Ontarians are highly sensitive to the costs and risks that would be associated with any agreement to achieve significantly freer bilateral trade. This sensitivity has focused on three types of issues:

1 Disruptions to output and employment during the process of restructuring, particularly in manufacturing, that would follow from a major lowering of trade barriers. At the extreme, there is a concern that the level of manufacturing activity in Ontario would fall off absolutely in the wake of such an agreement.

2 The potential for a loss of political sovereignty for Canada generally and Ontario specifically. Debate on the issue of economic gains versus political-independence losses is perennial in Canada, but its tone in Ontario is flavoured by the province's relatively favoured economic position (leading to the view that it has relatively less to gain) *and* political position (leading to the view that it has relatively more to lose).

3 The sense that greater economic integration, particularly in a special bilateral deal with the United States, would reduce significantly the ability of Canadian governments to engage in active 'managing' of the economy. Such management has been and continues to be a key part of the Ontario government's approach to the issues of provincial development.

These concerns help explain Ontario's resistance to any comprehensive bilateral trade agreement with the United States. Although there is general Ontario support for further progress towards multilateral trade liberalization within the framework of the General Agreement on Tariffs and Trade (GATT), we suspect this support reflects a preference for slow incrementalism over grand-scale initiatives on the trade front. (Were the European Economic Community, Japan, and the United States suddenly to agree on a significant new attack on all forms of trade distortions, Ontario's support for the multilateral approach would be severely tested.)

Weaknesses in the Ontario perspective

To summarize, our assessment of the Ontario perspective on Canadian trade-policy options is that it reflects the relatively favourable position the province has enjoyed since the old National Policy, based on protection and intervention by governments. Even though economists, both inside and outside Canada, have long recognized the aggregate economic costs associated with traditional Canadian policies, Ontario has resisted policy initiatives to reduce these costs. This is because Ontario – more properly southwestern Ontario – has been able to adapt relatively well to and benefit from policy and other opportunities for intervention. Significantly freer trade would fundamentally alter the structural environment for many Ontario manufacturing industries. Change can present opportunities, but it also means risks. Comparatively comfortable Ontario seeks to minimize risk or at least to face it in modest, manageable stages.

The basic weakness in this approach is that Ontario, no less than any active participant in world trade, can no longer effectively control the pace at which risk must be confronted. Competitive pressures from outside North America continue to mount, aided by the tariff cuts that were put in motion by the Tokyo Round of the GATT. A danger for the province, which is beginning to show up slowly but inexorably, is that the miniature replica subsidiaries that have been so important in the development of Ontario's tariff-sheltered manufacturing sector will be either shut down or relegated to nonproduction activities (such as servicing). Parent companies will relocate production facilities in the United States or, more likely, move their Canadian- and US-based branch plants to newly industrialized countries (NICs), which offer substantial labour cost advantages.

In short, much of Ontario industry is already highly vulnerable to foreign competition, irrespective of Canada's tariffs. This is particularly the case for producers of goods using standardized technologies (for example, textiles, clothing, and shoes) who find that Canada is and will continue to be at a huge comparative disadvantage in relative wage costs. But it is also true for a variety of industries (for example, metal fabricating and electronics) in which Ontario has the potential for long-term competitiveness but is failing to achieve true international cost advantages for reasons that are essentially policy-related.

We do not wish to paint an excessively gloomy picture of the Ontario economic prospect. Provincial government initiatives have been taken, many of them soundly based, within a strategic framework. Moreover, the Ontario economy has a number of strong sectors (for example, steel and telecommunications equipment) that meet the test of international cost-competitiveness. Unfortunately, the future success of even these industries is at risk, in this case from nontariff distortions that the United States has imposed on or strongly threatened for Canadian exports.

For example, there are pressures in the United States to include Canada in the 'voluntary' export restraint program that has already been forced on eleven other steel-exporting countries. In the area of urban mass-transit equipment, Canada is liable to subsidy investigations in the United States. And in telecommunications equipment, the United States is examining the linkages between Bell Canada and Northern Telecom as a potentially countervailable source of assistance to the latter's export capabilities.

To put the weakness of the Ontario perspective simply, the provincial view is based on an assumption that this country still has leverage and economic advantages roughly similar to those it had in the past. It does not. There appears to be an awareness of the challenges posed by the NICs, but the provincial government has not been proposing appropriate policies for responding to them. Ontario industry must become even more exposed to international market pressures and opportunities than it already is, with firms being forced by these pressures and induced through forward-looking government policies and greater foreign-market access to achieve increased specialization and, where appropriate, larger scale in their operations. In addition, even stronger measures must be taken to achieve an upgrading in the technology employed and effectively diffused in Ontario.

As noted earlier, Ontario has introduced policies that would help move the province in the direction of greater international cost competitiveness, and we will review some of them later. The key to success will be to encourage the firms that move towards the early, highly innovative phases in the product life cycle and not to support those that stay at the later stages, where competition with current and future NICs will be most intense.

Support for long-term quotas on imports of automobiles is an example of a policy for Ontario to avoid. Near-term assistance to the automotive industry makes sense, provided that it is temporary and contingent on effective measures by business and labour to improve the industry's productivity. If, instead, automotive firms and their workers are led to believe that they will be sheltered permanently from foreign competition, the incentive to achieve greater productivity will be severely blunted. Other industries experiencing similar competitive challenges, now or in the future, will naturally cite such protection as a model for the assistance they would demand to receive.

Even if consumers were prepared to tolerate protection's costs, in the form of inflated prices, today's trade environment presents another difficulty: the threat of counteractive US thrusts limits the range of instruments Canada or its provincial governments can use to encourage exports. The direction of policy debate in the US Congress suggests that any time the domestic market share of US firms is eroded or threatened by imports, Canadian exporters will be liable to contingency protection measures if they have received – or are even claimed to have received – firm- or industry-specific assistance from government.

Again, Ontario is far from ignorant of the US protectionist threat, often occurring under the label of 'reciprocity' or 'fair trade'. The province's response, at least as we read it, is to support Ottawa in its efforts to prevent any serious trade rift with Washington. In fact, Ontario goes further and endorses the prompt launching of another GATT round of multilateral trade talks aimed at stopping the drift towards protection. This is not a silly approach by any means, but it represents a 'leap of faith' in several respects.

One such leap is the belief that multilateral trade talks will begin in the relatively near future and will eventually succeed, but that their results will be, like those of past GATT rounds, quite incomplete and implemented at the traditional measured pace, leaving plenty of room for government management of the Ontario economy. Another is the assumption that even if the multilateral approach were to fail, the United States would not turn protectionist towards Canada, or at least not towards those products that Ontario is most anxious to export – especially cars. Such assumptions may be valid, but they carry degrees of risk similar to those Donald Macdonald spoke of when he referred, in an oft-quoted phrase, to the leap of faith involved in seeking a trade agreement with the United States, a subject to which we now turn.

THE CANADA/US TRADE OPTION

Following a meeting between Prime Minister Mulroney and President Reagan in Quebec City last March, substantial momentum has been generated to seek some form of comprehensive bilateral trade agreement between the two countries. If this momentum is to produce action, Canada will soon have to declare its interest in proceeding. Otherwise, this discussion will be aborted (as similar discussions have been several times during Canada's history).

Ontario probably has more concerns about the bilateral option than the rest of the provinces combined. Some of the reasons have been covered in what we have already said. Another is that Ottawa has purposely left vague the kind of agreement that might be reached. In the absence of a clear outline of what such an agreement might look like, critics of the bilateral option have controlled general public debate as it has evolved in Ontario. Focusing on the emotive phrase 'free trade', they have been arguing against an approach that is far more simplistic than we believe Ottawa would ever agree to endorse. In this section we seek to define aspects of a bilateral accord that might find general support within Ontario.

At the outset of this discussion, we make four assumptions that we believe are generally valid:

1 There is no inherent reason that bilateral negotiations could not proceed simultaneously with multilateral negotiations. On the contrary, this is what both Ottawa and Washington claim they want, and we see no basis for doubting these claims. Any notion that Canada could do better for itself in comprehensive multilateral trade talks by separating itself from the United States is naïve today. Japan and the United States will be the dominant players in the next GATT round, with Europe a shaky third leg in the major trade-power triangle. A Canada on its own would risk being essentially irrelevant. But a Canada in the process of negotiating a separate bilateral accord with the United States could bring its unique perspective to bear on the formation of a sensible North American position in the multilateral talks. Moreover, a forward-looking, innovative bilateral accord could serve as a useful prototype for the GATT talks and could also, over time, be expanded to encompass additional nations seeking to proceed towards trade liberalization at a faster pace than the GATT multilateral process might allow.

2 Similarly, there is no reason Canada could not combine movement towards a bilateral agreement with progress on what Sharpe (1972) set out as the 'third option'. The 'first option', it will be recalled, involves an essentially status-quo approach to Canada's trade rela-

tions with the United States. The 'second option' is to seek closer economic integration with the United States, which would be the consequence of a bilateral accord. The 'third option', which was billed originally as a distinct alternative to the other two, requires both that Canada improve the performance of its economy and that it seek to diversify its trade away from what was thought to be an excessive concentration on the United States. But if a bilateral accord were sufficiently flexible to allow meaningful policy scope for Ottawa and the provinces, the second option would not preclude progress on one of the third option's key objectives – better economic management. (We explore this point more fully in the third section of this paper.) Moreover if, as we strongly believe, a bilateral accord would result in greater Canadian economic efficiency over time, the trade-diversification objective of the 'third option' would be more feasible. Progress to date on this objective has been extremely limited, as reflected in the fact that over the past decade the United States has raised its share of total Canadian exports significantly.

3 The key to a bilateral accord for Canada would be the mechanics of the transitional arrangement negotiated. No one seriously contemplates an agreement whereby Canada would wake up one morning and find the trade barriers between this country and the United States had gone overnight. This is not the way trade agreements are implemented. (Since Ontario would need more complex transitional consideration than any other province – although Quebec would have broadly similar needs – we return to this issue below.) A critical point in our thinking is that in a bilateral accord, these transitional mechanics are far more likely to receive a treatment that recognizes Canada's unique situation than they would in the kind of multilateral agreement that can reasonably be anticipated from the next GATT round.

4 It makes little sense for Canada to evaluate the bilateral option with preconceived notions about what the United States would demand as a condition for entering into an agreement of this kind. The US position might carry a price tag too high for Canada to accept. If that turns out to be the case, Canada should be prepared to halt the negotiations and follow an alternative approach. Thus, having a viable alternative ready is a necessity for effective negotiation in the Canadian interest. But to refuse to negotiate because of concern about

what the United States would demand, without knowing what its non-negotiable requirements – if any – would be, strikes us as reflecting a victory of fear over reason.

Establishing a position – with the provinces

As we understand the process for negotiating a bilateral agreement, the first key decision point will come in the fall of this year. At that time, the Canadian federal government will have to decide whether it wishes to enter into the negotiation of such an agreement and, if so, what is the general nature of the accord it would be seeking to discuss.

It is important to bear in mind that although Ottawa's constitutional authority to negotiate treaties and to implement legislation affecting tariffs and other transborder measures relating to international commerce is clear, previous constitutional decisions appear to indicate that Ottawa can not unilaterally implement measures in areas that are under provincial or shared jurisdiction – for example, in the fields of industrial assistance and labour-market policies (Van Loon and Whittington 1981, 255-7; Russell 1973, 150-3). Given the economic and political difficulties of reaching an accord based on sectoral agreements, such as the 1965 Auto Pact, and given the apparent trade-policy sentiments of the Congress, the United States is almost certainly looking for Canada to propose a fairly comprehensive agreement, including items relating to both trade and investment flows between the two countries. The very comprehensiveness of the agreement would make it certain that areas of provincial jurisdiction would be involved.

The Mulroney government has launched a fairly extensive set of consultative meetings to hear the views of the provincial governments and the private sector on the bilateral option. These consultations will continue as the government formulates its position. What is at issue, from Ontario's perspective, is how its concerns as a provincial government will be fit into the detailed proposal the federal government makes to the United States. The answer is unclear to us, but it appears that Ottawa will make the basic 'go/no-go' decision after completion of its general consultative exercise. If the decision is 'go', the federal government will need to include provincial representation in the formulation of its actual proposal. Not only must provincial perspectives be included early because of the constitutional ramifications of any comprehensive agreement; there will also be important political aspects involving the need for provincial support of and adherence to the spirit of the accord if it is to be truly effective.

If our reading of the process is generally accurate, it obviously involves sensitive federal/provincial issues. The Ontario government has already expressed serious reservations about any comprehensive bilateral agreement.[1] A refusal to go along with a federal 'go' decision would probably not stop the Mulroney government and would risk alienating other provincial governments – several of which have already expressed strong support for such an initiative – as being obstructionist. On the other hand, if the Ontario government were either to support the initiative or decline to object to it, the momentum would gain a force that might be very difficult for the province to stop or reverse if the United States' demands or the mechanics being negotiated started looking unfavourable from the perspective of Queen's Park.

This situation creates something of a political dilemma for Ontario. About the only way out is for the province to clarify its concerns and seek assurances from Ottawa that they would be reflected to the fullest extent possible in setting the scope and nature of negotiations before any federal announcement of a decision to proceed further.

A negotiating position: Ontario's concerns

If Ontario took this route, some of the issues it might legitimately ask the federal government to clarify are:

- What provisions would be sought to permit 'opting out' for politically sensitive sectors (for example, those related to culture)? What would be the process of identifying such sectors on both the Canadian and US sides?

- What arrangements are anticipated for phasing in tariff reductions and limiting use of nontariff distortions in those industries included in the agreement? Would there be a basis for differentiating transitional arrangements among various industries? Would Canada seek different phasing-in provisions for the two countries, and how would the United States be likely to respond to such a request?

- What latitude would be allowed the provinces (and the states) to use stimulative policies to encourage regional development, exports, import substitution, and research and development? In short, how much necessity for fiscal- and regulatory-policy harmonization would be anticipated as part of the accord?

- What would be the relationship between the US and the Canadian dollar, both during the transitional period and over the longer term? If Canada were expected to prevent a currency depreciation for competitive advantage, could it also anticipate an opportunity to resist currency appreciation (from possibly large-scale capital inflows), especially during the transition period?

- What provisions would be made regarding the pricing of natural resources? Would the price of energy, for example, have to be the same (excluding transportation costs) to Canadian users and the US export market?

- What would be the arrangements regarding the flow of people back and forth across the border?

- Would there be a provision, especially during the transition period, to limit increases of US ownership in Canada? (This problem would arise if, as we would expect, Americans were quicker to see the opportunities from such a bilateral agreement than were most Canadians.)

- Would each country retain its own tariff and other trade policies vis-à-vis third countries (à la a free-trade area) or would these policies be made common (à la a common market)?

- What provisions would be made for subsequent expansion of the agreement if other countries wished to join?

- What would be the basic shape of the mechanism for settling disputes? How could the provinces have input to this mechanism?

At the foundation of the issues we have listed is the fact that a bilateral accord between Canada and the United States would not fit neatly into any of the traditional models of trade agreements. An economic union is not, in our view, going to get much support in Ontario or, indeed, in much of the rest of Canada because of its probable implications for this country's political sovereignty. A common market, involving a high degree of policy harmonization, would probably also go further than most Ontarians or Canadians generally could endorse. The closest pure model, despite the negative connotation that has come to be attached to the phrase, at least in Ontario, would be a free-trade area. Such an association would be much looser than that of the other two models, but it would still require careful and complex negotiations to pattern an accord that might be judged acceptable from an Ontario perspective.

To put the matter succinctly, a successful bilateral agreement would almost certainly be a two-nation understanding that took the shape of but went well beyond the staged approach to trade liberalization of the multilateral GATT framework. It would stop far short, as have all GATT rounds, of reaching a neatly defined final conclusion. Like the GATT approach, it would permit sectoral exceptions to general rules, it would be flexible in mechanics and in implementation, and it would place a good deal of emphasis on transitional arrangements. In short, if a bilateral negotiation were to be carried forward, it would entail the launching of a more formalized relationship between Canada and the United States, but it would not achieve anything like total integration between the two economies.

Such a bilateral agreement would require significant provincial input throughout the negotiation process, including enough pre-negotiation analysis by the provinces to achieve a broad consensus on the basic issues we raised earlier. It would also permit – and, in our view, require for maximum effectiveness – some clear-headed, practical thinking by all governments in Canada about what else this country must do to improve its long-term maximum potential for economic development. This would necessitate imaginative policy thinking about ways to achieve the 'third-option' objective, a subject to which we now turn.

BEYOND AGREEMENTS ON TRADE

Trade is a means to an end, not an end in itself. If a mutually satisfactory agreement with the United States could be negotiated, the transitional costs of adjustment should be more than offset, in the aggregate, by the following long-term benefits:

- Reduced likelihood of the United States' imposing arbitrary barriers on Canadian exports.

- Increased market incentives for shifting the mode of Canadian manufacturing production towards operations that benefit from greater specialization and, where appropriate, scale. (This would encourage what economists term 'static efficiency'.)

- Expansion in the horizons of Canadian business towards international markets and away from the formerly well-protected domestic market. (This would encourage, though not ensure, increased 'dynamic efficiency'.)

These results are what should be sought in pursuing the goal of sustained, high-employment growth in the Canadian economy. Ontario has probably been ahead of Ottawa in perceiving that this objective requires a clearer, more integrated strategy for growth than the country has had in the past. What concerns us is not the awareness of a need for change in Ontario, but the tendency in the province to downplay the risks to its ability to pursue the tactics it has proposed, especially those aimed at long-term protection for sensitive sectors (the automotive, for example), a failure to appreciate the gravity of the challenge of international competition (largely because the Ontario economy has been carried along by the recent US boom), and a tendency to underestimate the magnitude of the protectionist sentiment in the US Congress.

Ontario has been very active in providing industrial aid. It has given seed money and tax relief to small companies, allocated assistance to export marketing, and established a variety of regional development corporations. Most important from a strategic standpoint, Ontario has been deeply concerned about the country's weak performance in R&D and the adoption and diffusion of new technologies. Reflecting this concern, the provincial government has worked to foster awareness of emerging technological opportunities and to aid in the transfer of new technologies within the province. To assist this process, it has set up a number of technology centres (for example, in microelectronics and advanced manufacturing technologies). It has also established centres to promote university-business ventures.

Three areas in need of national policy

While crediting these initiatives, we believe that more strategic policy-making is required nationally, along with more hard-nosed attitudes provincially to the nature of the international challenge. To support an effective 'third option', we suggest launching national policy action in three primary areas.

An emphasis on building capital

First, for the remainder of this century at least, we must focus Canadian economic policy on raising the claim of investment on the allocation of the country's output. This means a movement away from the excessive focus on the equitable distribution of income that so dominated this country during a period of complacency about the trade environment it was facing. (The Mulroney government made significant moves in this direction with the May 1985 budget.)

Economists have to work to expand public understanding of the meaning of the term 'investment', which goes beyond plant and equipment to include the development, acquisition, and dissemination of skills and knowledge throughout our industries. We must also become more aware of the increasing need for enrichment of the human portion of the nation's capital stock through improved and more practical education and skill enhancement, both inside and beyond the formal schooling system. Achieving a larger share of national output for investment, broadly defined, will require that a significant reduction in governments' budgetary deficits be given the highest priority. We need to exercise care here, however, to differentiate capital from current budgetary spending items and to forward the capital-building objective that can be achieved in education and training activities.

A core-sector strategy for industrial assistance

Second, because industrial assistance uses increasingly scarce public funding, it must be allocated on a more solidly reasoned basis. Our preference is to move to a strategy of core sectors, determined on such economic criteria as linkages, feedbacks, and externalities, and away from what might be called a key-sector approach, based on how many votes will be won or lost. We suggest six sectors that merit the designation of 'core'[2]:

1 Arable land and water, because we need and must use and protect our natural advantages in agricultural, forestry, and marine production.

2 Mineral resources, more for wealth generation than for direct job creation.

3 Energy, to ensure its continuing availability at prices at or slightly below the world level.

4 Transportation, which is especially important for a country with the vast size and export-dependency of Canada.

5 Telecommunications, which we think will be the railways of the late twentieth and twenty-first centuries.

6 Education and skill enhancement for our current and future labour force.

A core-sector strategy must emphasize the longer- over the shorter-term planning horizon. It should promote the health of the general industry environment, not the survival of poorly managed firms, which must be allowed to fail.

Such a strategy could provide the foundation for an investment-oriented approach to macroeconomic stabilization, rather than one that is consumption-oriented. Periods of weakness in aggregate demand would be good times to look ahead and undertake capital expenditures for infrastructure needs in core sectors. The timing imperatives of these infrastructure requirements are not rigid, but they are central to the objectives of longer-term national development. Examples include upgrading transportation capacities and reforestation incentives.

If Canada pursued macroeconomic policies aimed consistently and effectively at increasing the claim of investment on the allocation of output and succeeded in achieving and maintaining world-class performance in its core development sectors, the country would be in a position of solid strength to negotiate a bilateral accord with the United States. It would also have enhanced participation in whatever takes place in the way of further GATT negotiations. (It would still, however, have to shape a broad range of framework policies within the context of whatever trade agreements are concluded.)

Improvement of the entrepreneurial climate

The third area of importance for Canada's – and Ontario's – building of a solid industrial structure for the future is the development of a framework of policies aimed at fostering a dynamic entrepreneurial climate within the country. Competition policy, regulatory policies, foreign investment policy, labour-market policies, and taxation policy must be shaped to meet the requirements of competing effectively in a tough, aggressive world, not the protected environment encouraged by the National Policy of 1879. The Mulroney government's recent shift in transportation policy and the transformation of the Foreign Investment Review Agency into Investment Canada are examples of what we have in mind. But trade policy is the keystone upon which to build this new framework. Until that is worked out, entrepreneurs will continue to be plagued by the uncertainties that have been so detrimental to Canadian growth performance in recent years.

Fiscal policy will be particularly significant for Ontario. If President Reagan's proposals for personal tax reform are enacted, top marginal tax rates for individuals in the United States will be significantly below those in Canada. This situation would be very damaging to Ontario's ability to attract and maintain highly skilled labour in the province, and the possibility makes it all the more imperative for Canada to get its budgetary position under better control.

Indirect taxes also need re-examination in the light of the imperative to competition. Canadian-based production faces a much heavier burden through a series of levies – sales taxes on equipment and supplies, capital taxes, and business and franchise taxes – than their US-based competition (Canada 1978, 141-2).

CONCLUSION

The Ontario perspective on Canada's trade-policy options is based on a fairly narrow view of the world. It reflects modest concern about the province's current economic situation, but that concern falls well short of alarm. The fact is that Ontario has fared reasonably well in a highly unbalanced economic world. It would be wonderful if Ontario's luck held, but we very much doubt that it will. Other regions of the country have not been so fortunate, and one finds far less desire there than in Ontario to stick with the status quo. We have often regretted over the years that this province's position on national trade-policy options has not reflected a longer-term vision.

In the past, Canada has lacked a comprehensive trade policy effectively linked with a realistic industrial-development strategy. Now, it has been forced to adopt a damage-control position. Given relatively weak overall manufacturing productivity, high unemployment had to be tolerated to hold wage gains down. A falling Canadian dollar relative to the US dollar has also been tolerated in order to reduce further the level of real wages within North America.

The Canadian economy can and must do better. To begin this effort effectively, we must clarify the nation's trade-policy objectives, putting them forward with an unemotional sense of the way the world trading environment is evolving. From that starting point, the country and all of its provinces can construct complementary policy initiatives to raise performance. Key to these initiatives must be the promotion of a more dynamic entrepreneurial climate throughout the country.

Canada/US trade relations are a crucial element in achieving this climate. More formal agreement on how they will be managed is of fundamental importance, but that management will be only a means to an end to be determined within this country's political structure. Fitting such an agreement into a new forward- and outward-looking framework is a job in which all provinces must be expected to participate. Unless Canada, with Ontario playing a leading role, decides to move quickly off the dead-end status quo, events in the world trade environment will pass this country and this province by.

NOTES

1 This concern has led the new Ontario premier, David Peterson, to announce the establishment of a new legislative committee to study the free-trade issue (see Christie 1985).

2 Most of these sectors, it might be noted, had been singled out for priority treatment in Ontario's Board of Industrial Leadership and Development (BILD) program.

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A Western perspective on Canadian trade options

Brian L. Scarfe

The Western Canadian position on trade-policy questions has traditionally been in favour of free multilateral trade and the abolition of restrictive tariffs, quotas, and other trade impediments. Since this goal is unattainable in today's world, a comprehensive bilateral free-trade arrangement with the United States would be a welcome compromise. Indeed, Canada already participates in bilateral tariff-free trade with the United States in a large number of areas, including various primary and processed commodities as well as automobiles and motor vehicle parts. These arrangements have been very useful in permitting Canada to build on its existing strengths.

The removal of Canada/US trade barriers from additional areas and commodity groupings would clearly be in the interest of all Canadians, viewed as consumers, provided the bilateral arrangements did not lead to the erection of more substantial, common North American barriers to trade with third countries, particularly newly industrializing countries around the Pacific Rim and elsewhere. It is important to recognize that the United States has strong protectionist tendencies, particularly against noncontinental imports, and especially when the US dollar appears, from a trading perspective, to be significantly overvalued. In consequence, we should not enter any trade-creating arrangement with the United States that would lead to significant trade-diversion from our other important trading partners. The last thing we should want is further restrictions on imports from rapidly growing Pacific Rim countries (including quotas on Japanese-

Dr Scarfe is chairman of the Department of Economics, University of Alberta.

made automobiles), since they would inevitably undermine our ability to export primary and processed commodities, as well as technical expertise, to these important offshore market areas.

Most producer groups would also stand to gain from bilateral free trade. The main exception would be firms that were unable to adapt efficiently to the longer production runs that a larger market area would provide and thus could not lower their costs sufficiently to meet new, external competition. This problem of adjustment would probably lead to relocation costs for the employees of these firms. But, one might ask, why has Canada been protecting the income of these groups from market forces all these many years when the livelihoods of many other Canadians have not been so protected?

There are basically five arguments for Canada's entering a bilateral free-trade arrangement with the United States (see Wilkinson 1985, 2-3):

1 It would permit the rationalization of Canadian manufacturing processes and the attainment of economies of scale.

2 It would encourage technological diffusion within industry and expand our research and development efforts.

3 It would stimulate overall efficiency by exposing Canadian industry to the greater competition that a larger market area provides.

4 It would enable Canada to exploit further its comparative advantages through increased specialization.

5 It would eliminate the ongoing need to fight continual battles to counter US protectionist measures.

Against these productivity gains there would, of course, be some adjustment costs, which could be minimized by the phasing in of a comprehensive bilateral free-trade arrangement. There might also be some loss of sovereignty in the sense of discretion to protect certain groups of employees in particular industries. But if one of the gains is to secure the continuity of markets that we already depend upon heavily to generate income and employment, these offsetting costs should not be permitted to hold up a change in our trading relationship that clearly has much that is positive to offer.

This last aspect, although defensive in nature, is actually quite fundamental. Indeed as the government of Alberta has noted:

> If Canada is to continue to benefit from trade with the United States, and wishes to be in a situation to take advantage of new and expanding export opportunities, then the Canadian business sector must be in a situation of greater stability and certainty regarding its exporting activities. The private sector cannot make a long-term commitment to expensive marketing and investment expenditures in a climate of uncertain trade relations with its largest market. (Alberta 1985, 4)

ADJUSTMENT TO CHANGES IN THE TERMS OF TRADE

A lessening of restrictions on domestic imports acts like an increase in the real exchange rate faced by the affected industries.[1] That is, the price at which import-competing firms can sell their products initially falls relative to their production costs, thus squeezing profit margins. Although the increase in the real exchange rate can be offset for the affected industries by a fall in the nominal exchange rate (that is, in the US price of one Canadian dollar), such an adjustment may not be sensible from the perspective of unaffected industrial processes.

On the other hand, a reduction in restrictions on foreign imports acts for our exporters like a fall in their real exchange rate. The prices at which they can sell their products increase relative to their production costs, thereby initially improving profit margins. The reduction in the real exchange rate can be offset by an appreciation of the value of the Canadian dollar, but such a change would lead to some tightening of cost-price margins in other industries.

From these two statements, it is not difficult to see that a move towards bilateral free trade necessarily implies changes in the terms of trade facing Canadian industries. Some industries would experience an improved output price relative to their input prices because of their enhanced access to foreign markets, while others would experience the opposite situation because of increased foreign competition in their existing market areas. In consequence, although the aggregate terms of trade for Canada as a whole might not be much affected, the maximum productivity gains obtainable from bilateral free trade can be achieved only if resources are appropriately reallocated both between and within individual Canadian industries. This reallocation would inevitably entail some adjustment costs.

However, these adjustment costs are something we deal with all the time. For example, many of Canada's primary producing industries are affected by severe movements in their terms of trade. The resulting instability of income, employment, and asset values has serious effects on the communities in which the firms are located. In most instances, these communities survive the downswings with the help of various forms of adjustment assistance, such as unemployment insurance benefits. On the other swing of the roundabout, they are sometimes forced to adjust to extreme boom-town conditions.

Unlike many of our resource-producing industries, which are geographically dispersed, most of our manufacturing industries are located in urban areas that are of significant size and have a well-diversified industrial base. Nevertheless, income and employment in these industries are often sheltered by tariff and quota protection. Apparently, we choose to shelter certain jobs from the vagaries of foreign competition, while leaving other jobs unprotected.

In addition, income and employment in our manufacturing industries are sometimes also sheltered by adjustments in the nominal exchange rate that serve to stabilize the fluctuations that would otherwise occur in their real exchange rate when, for example, their terms of trade move adversely because of rising resource-commodity prices in world markets. In the 1972-4 period, the Canadian dollar was permitted to depreciate in response to rapid monetary expansion notwithstanding the fact that this fall was clearly perverse vis-à-vis the contemporary improvement in Canada's overall terms of trade, which were dominated by our basic comparative advantage in resource-intensive products. Moreover, the perverse depreciation further destabilized income and employment in our resource-producing industries and enhanced the degree to which we imported foreign inflation.

My conclusion from this experience is that we should not get overly excited about the adjustment costs that would emerge from a comprehensive bilateral free-trade arrangement with the United States. As Helliwell (1985) puts it, to provide a future with jobs, we need to generate jobs with a future. Jobs that require more than infant-industry protection are not jobs with a future, and Canada would be better off letting them disappear. Adjustment assistance should be provided, through our existing social safety nets, to the individual families involved, but firms and industries that require continuous government protection for their survival are a direct burden on our quest for fuller employment. To use protectionist devices to shelter existing jobs in declining industries is no panacea for full employment because this protection undermines the economy's natural flexibility to create more and better jobs elsewhere.

REGIONAL TRADE EFFECTS OF EXCHANGE-RATE MOVEMENTS

Although in recent times the Canadian dollar has often looked weak in relation to the high-flying US dollar, in actual fact it has been strong in relation to European and many other currencies. One consequence is that the US recovery from the 1981-2 recession has pulled along with it those sectors of the Canadian economy, such as automobile manufacturing, that North American protective barriers shelter from third-country competition but has left mired those sectors that are exposed to third-country competition in external and US markets. The latter situation is that of our resource-based industries, which is one of the main reasons our overall recovery has been half-baked in comparison with that of the United States.

In the short run, the international value of the Canadian dollar is determined by conditions in the world money market. In consequence, preventing substantial changes in the US dollar price of one Canadian dollar (the exchange rate) normally requires us to adjust domestic interest rates to match rather closely the swings in similar interest rates in the New York money market. Those changes that are permitted to occur do, of course, influence our trading competitiveness. A fall in the exchange rate ordinarily enhances the competitiveness of domestic producers in both foreign and import-competing markets, while it increases, to some extent, domestic production and living costs. A rise in the exchange rate tends to have the opposite effects.

Our trading competitiveness, however, does not depend only upon the US dollar exchange rate. It also depends upon the value of the Canadian dollar in terms of other currencies. Given the close ties between the Canadian and US dollars, a strong US dollar ordinarily implies a Canadian dollar that is strong in terms of these other currencies even if it looks rather weak in terms of the US dollar. As the US dollar declines in relationship to the Deutschmark and the yen, the Canadian dollar falls in terms of these currencies, but perhaps not quite as far. Thus, when the overwhelming trade deficit in the US balance of payments inevitably begins to exert significant downward pressure on the US dollar, Canada's competitiveness against third-currency countries will be enhanced.

Some of these competitive gains will be frittered away in higher domestic inflation. However, this inflationary response will be contained by the high rate of unemployment that still pervades much of the Canadian economy. In consequence, there will be some restoration of profitability to many of our industries that have faced severe competition from non-US producers in response to the enormous appreciation of the US and Canadian dollars of the last few years.

This shift will be good for regional balance within the Canadian confederation since the resource-producing periphery has been much more severely affected by the strength of the US dollar than has the secondary-manufacturing heartland, in large part because the expansive North American automobile industry has been sheltered significantly from third-country (especially Japanese) competition by tariff and quota arrangements. Indeed, this protection ought to be unwound, for the benefit of consumers, as the values of the two dollars fall and thereby make tariff and quota protection of this industry much less necessary than it seems to have been recently. Incidentally, such a move would also reduce somewhat the inflationary side-effects of dollar depreciation.

TRADE TIES AND INVESTMENT TIES

There are those who fear a comprehensive bilateral free-trade arrangement with the United States because of what it might entail in foreign control of our domestic economy and the degree to which we can pursue independent taxation and regional-development objectives. In my view, these fears are likely to be misplaced.

First, it should be noted that much of the foreign control of Canada's manufacturing industry occurred as a *result* of the Canadian tariff; subsidiaries were created by foreign-owned companies to avoid tariff payments on production directed towards Canadian consumers. Second, foreign investment is a two-way street. We should expect a movement towards bilateral free trade to induce some foreign concerns to reduce their holdings of Canadian assets while others increase theirs. It should also induce some Canadian concerns to increase their holdings of US assets while others reduce theirs. These offsetting moves would be a natural consequence of the geographical rationalization of production facilities that bilateral free trade would bring about. Moreover, by altering cross-border asset evaluations, a flexible exchange rate could ensure that these effects largely balance out in aggregate terms.

Third, we are already fundamentally constrained in reaching our taxation and regional-development objectives by our virtually complete integration into the world – or New York – capital market. For example, the fact that Canadian personal-income-tax rules concerning mortgage-interest deductability differ from those in the United States has already caused very different housing-market reactions to high and volatile interest rates on either side of the border. High real interest rates would not have had such a catastrophic effect on housing starts in Canada if we had the same personal-taxation arrangements as the United States. More generally, in an integrated capital market, when taxation systems generate distinct differences in the user cost of capital to various agents, these differences always distort the allocation of capital investment across alternative investment opportunities.

This problem of 'tax harmonization' has, however, been with us a long time. It will remain as long as we continue to operate, as we must, as a small island in the large sea of world capital markets. Bilateral free trade, whose direct effects would be on the current account of the balance of payments, not the capital account, is not likely to add significantly to the constraints we already feel because of our close capital-market ties with the United States economy.

Finally, regionally based industrial-development schemes and other government distortions to the free flow of goods and factors *within* the Canadian common market may become *more* constrained as a result of the greater discipline that bilateral free trade would impose upon us. Perhaps we should conclude that this outcome would be favourable for economic efficiency in Canada. We should recognize, however, that in many instances these distortions represent the wishes of powerful vested interests. In consequence, the movement towards bilateral free trade will be fraught with significant internal political difficulties, quite apart from the external ones. Nevertheless, this bold initiative surely must now be pursued.

THE ENERGY SECTOR

The recent Western Accord has made substantial progress towards the removal of the worst features of that regionally specific, federally imposed fiscal-restraint policy better known as the National Energy Program (NEP).[2] Some aspects of the Western Accord affect trade relationships with the United States.

First, the price of conventional old oil will be deregulated and allowed to rise to world levels, which are themselves expected to remain flat or decline somewhat further over the next few years. There will no longer be a separate new oil reference price, and prices for new oil will decline to reflect conditions in the North American segment of the world marketplace. Moreover, with the deregulation of old oil prices, the petroleum compensation charge and the oil export charge will disappear. Also, the National Energy Board will freely permit short-term transborder purchases and sales of crude petroleum, save only for *force majeure* clauses, although export contracts lasting longer than one year for light crude and petroleum products (two years for heavy oil) will still require prior Board approval.

Second, natural gas prices will soon undergo phased deregulation at both the Alberta and US borders and will probably fall in the process. To ensure both economic efficiency and equitable internal prices, the rules set by the National Energy Board for the export of natural gas should be further relaxed. Indeed, in my view, Canadian natural gas should be allowed to penetrate all the markets in the northern United States in which it is able to compete without subsidy.

It is, of course, difficult to see how we could have total deregulation of the domestic natural gas industry, given the pipeline distribution systems and utilities involved in getting the gas to the final consumer. However, the removal of the Canadian ownership charge and the four-year phasing out of the petroleum and natural gas revenue tax will reduce the degree to which natural gas is unfairly treated relative to electricity. Whether reductions in provincial royalty rates on natural gas will be required as deregulation occurs remains to be seen.

Third, the part of the Canadian petrochemical industry that uses natural gas and gas liquids as an input received an initial jump start when Canadian natural gas prices remained well below those in the United States and elsewhere. Over time, however, the cross-border difference in gas-input prices has been eroded, reducing the effective protection for Canadian producers. Indeed, given the existence of significant US import tariffs on petrochemical products, Canadian producers now find themselves at a competitive disadvantage. Deregulation, which will lead to a common cross-border price for natural gas, transportation costs apart, needs to be accompanied by an arrangement for bilateral free trade in petrochemical products and particularly for the elimination of US import restrictions on Canadian-made petrochemicals.

Finally, the Petroleum Incentives Program will be phased out on both Canada lands and provincial lands. This change should result in a more efficient pattern of exploration and development and reduce government expenditures in the energy area in a way that will offset some revenue losses. It will also end the arbitrary NEP discrimination against foreign-owned energy firms operating in Canada. Presumably, also, the retroactive back-in provision for Canada lands will be eliminated, and, more generally, no further experimentation with Canadianization distortions will be contemplated. These changes in the investment climate are essential if we are to successfully negotiate a comprehensive bilateral free-trade arrangement with our neighbour to the south.

NOTES

1 The points made in this section may be compared with those made by Wonnacott (1985, 3-4).

2 For further comments, see my paper (Scarfe 1985).

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Discussion

JOHN CRISPO (University of Toronto): I'm not sure I understand the motivation behind Quebec's position on free trade with the United States. It is more vulnerable than Ontario to the fallout from free trade, yet the Quebec government is for free trade, while the leaders of all three Ontario parties are against it. Is the Parti Québécois' real motivation political in the sense that it thinks there might ultimately be some sort of North American common market within which Quebec could assert political sovereignty with no economic risk?

RODRIGUE TREMBLAY (Université de Montréal): There's no difference between federalists and indépendentistes on this issue. Both the Quebec Liberals and the PQ are committed to free trade. Their stance derives from a cold-blooded economic analysis. Quebec is east of Ontario, Canadian economic activity is moving westward, and the gate for Quebec is south. For many Quebec industries – paper, textiles, transport equipment, petrochemicals, and so on – the development of trade flows with the eastern states is a way to expand. The soft industries, which are being kept alive now by quotas or subsidies, have a better chance of survival if they can attempt to adjust to a large market than if they remain in a small market, drifting towards oblivion.

There is a political factor here, however, in that it was a political combination favouring free trade – Quebec, the Maritimes, and the West – that put the Mulroney government in power. Provided Ontario exercises some benign neglect towards free trade, I think we will get it. In the past, the main stumbling block has been lack of political will. To take the first steps, you need political will.

The political will is present in Quebec but we are realistic about what free trade would mean. It would entail a lot of adjustment. As I have said, we would need arrangements that take account of this reality. I think we can negotiate them, using rational arguments with the Americans, since the adjustments would be taking place in Canada.

DWAYNE WRIGHT (Business Council on National Issues): If we use Professor Tremblay's economic analysis of the domestic situation in Canada, we realize that we don't have much of a common market within this country. Does the reasonably widespread geographic interest in some form of closer economic relations with the United States mean the prospect of reversing the balkanization of our own economy?

BRIAN SCARFE (University of Alberta): I'm not sure that we are making many strides with that. But it might be that negotiating a comprehensive bilateral trade agreement with the United States would force us to drop our own internal barriers. Maybe we need such a catalyst to do the things the Macdonald Commission will probably tell us to do.

CARL BEIGIE (Dominion Securities Pitfield Limited): I don't sense much forward momentum in this area. In Canada/US negotiations, it's not at all clear to me how limits would be placed on either the provinces or the states to force them to move away from inward-looking policies. A treaty would help, but my sense is that it's the spirit that is critical. Trade agreements can just go so far. Yet I am skeptical as to the spirit's being there.

RODRIGUE TREMBLAY: When we talk about procurement measures at the provincial or state level, we're talking about nontariff barriers, and I'm less optimistic about them than I am about tariffs. But as I mentioned, let's do it by steps. Let's take ten years to remove the tariffs and simultaneously or later on have a twenty-five-year schedule for dismantling the nontariff barriers case by case with a lot of horse trading.

I would add that Canada/US free trade would be one way for Ontario to achieve what it has always asked: a freer internal Canadian market. A North American free-trade arrangement would create a framework for slowly dismantling the Canadian provinces' nontariff barriers. So it would be to Ontario's interest to join Quebec and other regions in promoting North American free trade.

JAMES McNIVEN (Nova Scotia Department of Development): In principle, a Canadian common market sounds good for all the provinces. But it also sounds like a deal to make Canada safe for Ontario. The trade would be in one direction. I doubt that we would see a sudden growth of manufacturing in British Columbia to sell in Ontario.

If you locate on a map the headquarters of all the major corporations in the United States, you can see they are all over the place. Most Canadian corporate headquarters, however, aren't more than sixty miles from this room. That difference tells you something about the nature of the two economies. The United States' is dispersed across the whole country, while ours is jammed into one little strip. So I have to agree with the other speakers: the only way that the Canadian economy is going to open up for Ontario is if Ontario opens up so the rest of Canada can participate in some of the manufacturing.

Let me give an example. Nova Scotia's world-competitive blueberry crop was just whacked with a duty because Ontario is protecting its wine. Now, I would really rather buy my wine from California or France if it would help keep about four thousand blueberry-pickers at work in Nova Scotia. What's going on in this country is a mutual process of self-mutilation. The dollar's going to keep falling and trade's going to become more difficult until we all sit down and try to work out a co-operative arrangement instead of calculating how can I get the most for me and leave you dangling. The critical time for such adjustment is coming in the next short while because we can't keep running along the track as we have been.

ED SAFARIAN (University of Toronto): I have two questions for Carl Beigie about the core-sector concept. First, how do we get core-sector support, which I presume is some sort of fiscal or regulatory support, if we have gone into a free-trade arrangement with the United States? Are the core sectors to be exempt from the free-trade arrangement? Second, how do we arrange for these sectors in the federal/provincial context? In some of these sectors you mentioned, the provinces have larger fiscal and regulatory powers than the federal government.

CARL BEIGIE: To answer the second question first, if it has to be done, it has to be done and the heck with federal/provincial relations. Quite frankly, I think the federal/provincial issue is an excuse used constantly in this country for not getting on with it. In my view, the role of the federal government is to make it clear why a particular approach to policy is both necessary and fair to all regions of the country. If the provinces don't want to opt into this kind of thing, where the heck is this country going?

The more serious question in my judgement is how we are going to handle this within the Canada/US context. You certainly put your finger on one approach – to opt out of totally free trade in some of these areas. But really, much of what I have in mind is a question of regulation. As a nation, we have to keep a degree of sovereignty over the regulatory approaches we can use, and it has to be sufficient to permit us to use smarter policies than the Americans. To take a simple example, why should cleaning up our forestry management represent a serious problem in Canada/US relations? Or in dealing with water, why should we have to bow to a regulatory framework totally determined by the United States?

SIMON REISMAN (Reisman and Grandy Limited): The question of time for adjustment is probably a critical one. The hard fact is that the major restructuring in a Canada/US deal would have to be done by Canada – which would be fair because although the United States would no doubt benefit considerably from a free-trade arrangement, it wouldn't do so to anything like the degree that Canada would.

I don't know how widely it is known that back in 1948, the last time Canada tried to negotiate a broad free-trade agreement with the United States, the Americans were ready to tolerate a fairly extended period during which Canada would have been permitted to use a variety of restraints that would forward the adjustment and restructuring process.

I'm not going to go into all the details and the history. The point is that in 1948, the Americans were willing to play. They recognized that we needed an asymmetrical arrangement, partly because of the nature of the two economies and partly because of the fears and uncertainties and lack of confidence that were so common in the Canadian community, particularly among labour and politicians.

Today I think we'd also need a period to restructure. If nothing else, it would provide a more acceptable arrangement at home. But the Americans are not happy about the way we've handled the transitional period in the automotive sector. Twelve years have gone by, and we've still got escape clauses and safeguards and many people act as if they're cast in concrete.

So the question I put to anyone who would like to address it is this: given that the pure economic and trade benefits would not be symmetrical and given further that the United States has had disappointing experiences with transitional periods in some sectors in the past, would the Americans be willing to play that game? And what offsets would we have to lay on the table to attract them to play it?

JAMES McNIVEN: That's the point I was making with the reference in my paper to Charlie Brown and the red-headed girl.

CARL BEIGIE: My answer is yes, they'd be willing to play, provided it was clear this time around that there was no question whatsoever that this was a transitional deal, not a permanent one. I've talked to a number of people in Washington in the trade-policy area, and I have never had one deny Canada's need for some type of transition. They agree that Canada needs safeguards in any kind of agreement with the United States. But as someone once said, the Americans need safeguards against safeguards. I think they would want an absolutely concrete commitment that at a particular point the transition would end.

BRIAN SCARFE: This time around, we probably would need to bite the bullet and go somewhat faster than we've done in the past. We would have to provide assistance by helping families that are affected, not by shoring up for any long period industries that might die in the process.

RODRIGUE TREMBLAY: An agreement has to work both politically and economically. An asymmetrical adjustment period would be a political necessity in Canada. It would also be rational because the starting positions of the two countries are not the same. If asymmetry seemed rational to the Americans in 1948, I don't see why it would not seem rational today, especially since Washington and Ottawa are now much more open to the idea of reaching a working agreement. The ten-year period in the bill in front of the Congress for free trade with Israel suggests the Americans are ready to accept a long period of adjustment.

RICHARD LIPSEY (C.D. Howe Institute): A word of warning on safeguards: they're a two-way street. When the Swedes were working out the terms of becoming an associate of the EEC in the early 1970s, they were so concerned that they insisted on a lot of safeguards that were later used against them when they began to penetrate Europe. Because of the Canadian inferiority complex, it never occurs to us that we may do so well that safeguards might be used against us. But let's be careful. Every time we propose a safeguard in bargaining, we should consider how it would look if it were used against us.

SIMON REISMAN: I used the word 'asymmetrical' not only in reference to what we need but in reference to what the Americans are willing to accept. I am thinking in terms of what would make it politically possible for Canadians to do the risky thing. Is the United States sufficiently concerned with establishing a long-term across-the-board relationship with Canada that it would be willing to accept a transitional period during which certain safeguards would be required to facilitate the needs of new investments and the restructuring of industry in Canada?

CARL BEIGIE: I think we might get the US administration to go along with what Simon Reisman has suggested, but I view it as almost impossible to get Congress to go along with it 100 per cent.

SANDY VOGELGESANG (Economic Minister-Counselor, United States Embassy, Ottawa): There have been a number of questions addressed to the United States. Perhaps I can respond to some of them.

First of all, the US/Canadian trade relationship is not a one-sided love affair. The US government is very interested in greater trade liberalization between the two countries. Indeed, we are interested in greater trade liberalization across the board. We would prefer to pursue this liberalization multilaterally. As Sylvia Ostry made clear, we would like to have the governments of Canada, Japan, the United States, and other nations all working towards having a new round of multilateral negotiations. At the same time, we think it makes good economic sense for Canada and the United States to pursue freer bilateral trade. A bilateral arrangement would probably hold greater economic advantage for Canada. But we feel it would be important for several reasons, including providing a model for the multilateral work.

Second, there have been questions about adjustment by Canada to a bilateral arrangement with the United States. That is one issue that both governments would have to address in negotiations. The terms of the US/Israeli trade agreement suggest some of the kinds of safeguards that could be considered.

Third, it is important to note that the key point in the current debate over freer trade is for Canada to decide what it wants to do. Representatives of the US government have not said a great deal because we appreciate the political sensitivity of the trade issue, as evidenced by the Canadian election of 1911. We fear that if we were to say a great deal, we would interfere with the discussion in Canada. Therefore, we are waiting for you to put your preferred option on the table. At that point, we will deal with it even more seriously than we already have in terms of looking at several preliminary ideas. But until you have decided whether you want to talk with us, it is inappropriate for our industry, for our labour unions, and certainly for our government representatives to say a great deal.

Finally, the window of opportunity for proceeding with bilateral freer trade is very small. Trade protectionism is acute in the United States, our trade deficit may rise to $150 billion US this year, and the economic recovery may soften. In addition, we have political realities of our midterm elections coming next year and the probable opening of the next presidential campaign. I think there's a very special opportunity, a historic one for both our countries, but we should be aware how small that window is and how rapidly it will close.

RODRIGUE TREMBLAY: That last comment is very relevant to the subject of federal/provincial relations. The federal government is now on the spot. It has to move quickly to put on the table the measures that it is willing to negotiate with the United States. But these measures have to be raised within Canada before they are put to the Americans. The sooner this is done, the easier and more open negotiations with the United States will be. If the provincial questions are settled ahead of time, we won't see things brought in through the back door of negotiations.

The recalling of 1911 is a red herring, though it's been raised many times. It was not free trade that defeated the Liberals then. When a party has been in power from 1896 to 1911, it can be defeated by any piece of floating material that goes by. Opponents are always against what the government does because they are trying to defeat it. I don't think free trade was very unpopular in 1911. Rather, Laurier was falling politically by that time. He tried to flow with free trade, and he sank anyhow. Free trade is not that unpopular today either. The Liberals' loss of last year's election was not interpreted as a loss because of their having proposed sectoral free trade.

What is important is that the 1986 and especially the 1988 elections in the United States may change the political situation. So I would advise the deputy ministers in Ottawa to get to work quickly with the provincial governments – especially those of Ontario, Quebec, and British Columbia, whose industries would be most affected – so that Canadians won't go into negotiations with their backs first. Then we can develop Simon Reisman's argument with the United States, with the provincial and federal governments offering a united political front. The federal government has the ball now, and it has to play it.

CARL BEIGIE: We haven't discussed the real issue in federal/provincial relations: what the United States might try to achieve with Canada with respect to third countries. My own sense is that the regional perspectives in this country might change a lot depending on how the Americans chose to run their policy regarding the rest of the world. An illustration comes from the auto industry. From an Ontario perspective, it might be nice for Canada and the United States to agree to hit the Japanese hard on cars, but if the Japanese were then to use some of their leverage of material purchases so as to adversely affect the Canadian West, there would be quite different views on all these matters.

BRIAN SCARFE: That point was alluded to in the statement that only 10 per cent of our trade is with the Pacific Rim. That trade has been growing very fast, and it's certainly frustrated by North American protective barriers against those countries' particular exports and by effective protection against further processed goods, such as paper board and plywoods coming out of Western Canada. If a trade war develops between Japan and the United States, Western Canada will be very much a loser.

PART III: THE IMPACT OF NEW TRADE AGREEMENTS ON DOMESTIC ECONOMIC POLICY

Trade and macroeconomic policies

John F. Helliwell

Most discussions of trade relations and the economic effects of changing them focus on the microeconomic aspects, with an eye on which industries and which regions will be winners or losers and on the size and distribution of the potential gains and losses. The purpose of this paper is to focus instead on the implications that various trade policies have for the conduct of macroeconomic policies. There is also the larger issue of whether, for any given set of trade policies, a case exists for a particular international orientation for Canada's fiscal, monetary, and exchange-rate policies.

For both questions, it is useful to distinguish our bilateral relationships with the United States from our multilateral relationships with all countries. This distinction has always been necessary for the discussion of essentially bilateral trade policies, such as the 1964 Auto Pact with the United States, but since the 1971 breakdown of the Bretton Woods system of pegged exchange rates, it has become necessary for the discussion of macroeconomic policies, too.

As long as the US dollar was the centre of a world system of fixed exchange rates, the Canadian choice between fixed and flexible rates was not much affected by the fact that the currency to which we were pegged (when we were pegged, from 1962 until 1970) was also the currency of our largest trading partner. Things are very different now that the US dollar is perhaps the most volatile of all the major currencies. Since the mid-1970s, the effect of Canadian monetary and

Professor Helliwell is a member of the Department of Economics, University of British Columbia.

exchange-rate policies has been to produce a trade-weighted exchange rate that is less volatile than the Canadian dollar price of either the US dollar or other major currencies. Thus, a decision now to track the US dollar more closely would involve more exchange-rate volatility, both real and nominal, with respect to our other major trading partners. I shall discuss later the pros and cons of this and alternative strategies for monetary and exchange-rate policies. For now, I wish only to establish the point that for Canadian macroeconomic policies and policy co-ordination, the distinction between bilateral and multilateral orientations is more important than ever before.

I shall proceed in two stages. First, I shall recount some of the Canadian and international evidence about the effect of economic openness on the scope for and effects of macroeconomic policies. Then I shall discuss some alternative monetary and exchange-rate strategies.

MACROECONOMIC POLICIES IN OPEN ECONOMIES

Everyone understands in a general sense that closer economic interdependence, of the sort brought to the North American automotive industry in the years following the Auto Pact, leads the economies involved to more parallel movements in employment and income. For those who might have previously had doubts, the transmission to Ontario of the recent upsurge in US car demand provided ample evidence. In the extreme case of components' moving back and forth across a border at several stages of manufacture, anything that influences aggregate demand on one side of the border will have almost equal effects on output on both sides, and government spending, whether in Minneapolis or Toronto, will have similar effects in Detroit and Oshawa.

There is a sense in which the longer-run goals of Canadian trade policy have long been easier access to larger markets and, nonetheless, preservation of domestic employment in the face of greater competition from more open world markets. What has perhaps changed over the last decade is the extent to which greater economic integration is flowing more from the decreasing costs of worldwide communications and transport than from trade negotiations or tariff reductions. This pattern is likely to continue over the next two decades, since tariffs are already down to fairly low levels and the frontier-jumping powers of electronic information-transfer and management are just starting to be applied. With scores of competing bids available at the flick of a switch, local suppliers can no longer rely on distance and ignorance to provide a market niche: they must either develop a durable economic advantage that exploits their ability to foresee emerging local markets or fall back on calls for local-purchase clauses and other instruments of the widening arsenal of nontariff barriers that increasingly dominate the real-world practice of trade policy.

Labour mobility

Everyone understands that integration of production and hence greater trade flows imply more international co-ordination of business cycles, whether caused by or offset by national economic policies. Much less attention is paid to the effects of the international linkage of capital and labour markets. The economic effects of migration have been of profound importance for millenia but have seldom received due attention, especially in the study of macroeconomic policy, which has long maintained the convenient fiction that the population level is economically exogenous. Yet economic growth and fluctuations have been either initiated or fuelled by economically motivated migrants searching for yellow gold in Australia or the Yukon, seeking black gold in Louisiana or Alberta, growing golden wheat on the Western plains, and taking jobs as guest workers in one of the richer countries of Western Europe.

With many countries insulated from external migration by barriers of language, education, and custom, the economically important migrants are often from the reserve army of underemployed agricultural workers, rather than from other countries. Intersectoral and interregional migration are also important for the countries of the Organization for Economic Co-operation and Development (OECD), where the average agricultural share of total employment fell from 21.7 per cent in 1960 to 9.4 per cent in 1983.

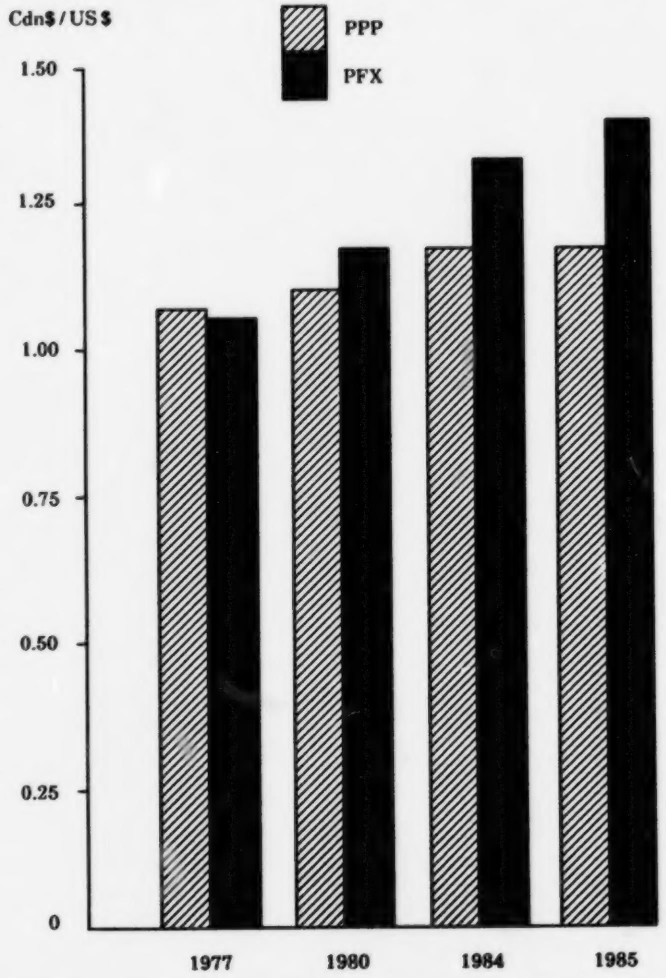
What are the implications of migration for macroeconomic policies? First, migration is an important factor in increasing the international equalization of real wages and unemployment rates. Immigration has, therefore, tended to be encouraged officially in times of perceived shortages of skills or of population, and discouraged in times of high unemployment. When countries move towards greater economic integration, the greater mobility of goods may be followed – as in the case of the European Economic Community – by attempts to increase the ease with which labour services can be traded, whether by full citizenship rights, guest-worker privileges, electronic banking in other countries, or simply fewer border formalities facing tourists, temporary workers, and the inevitable illegal migrants. Any move towards a more bilateral orientation of Canadian trade policy would be likely to lead to pressures for greater labour mobility across the forty-ninth parallel and consequent harmonization of overseas migration policies. Both of these changes would entail an unlikely reversal of the tightening of migration policies that has occurred over the past decade in both Canada and the United States. I therefore suspect that although transborder flows that involve a large element of trade in labour services will continue to grow in variety and scale, there will not soon be a return to the more open Canadian migration policies of the 1950s and 1960s. Thus, the earlier Canadian evidence about the important effects of induced migration (Helliwell 1974) is likely to provide an upper-bound estimate of its current importance.

Capital mobility and exchange rates

What about capital mobility? There is no doubt that continual changes have made all forms of capital more footloose. The increased mobility of capital, which has generally been resisted rather than nurtured by policy changes, has fundamentally changed the domestic and foreign effects of macroeconomic policies. Mobile capital can be a stabilizing or destabilizing factor in the international economy. In the standard argument for flexible exchange rates, mobile speculative capital is supposed to iron out short-term fluctuations in exchange rates and thus keep exchange rates close to the level that equalizes purchasing power at home and abroad. In the same view, mobile capital also tends to equalize real interest rates in various countries.

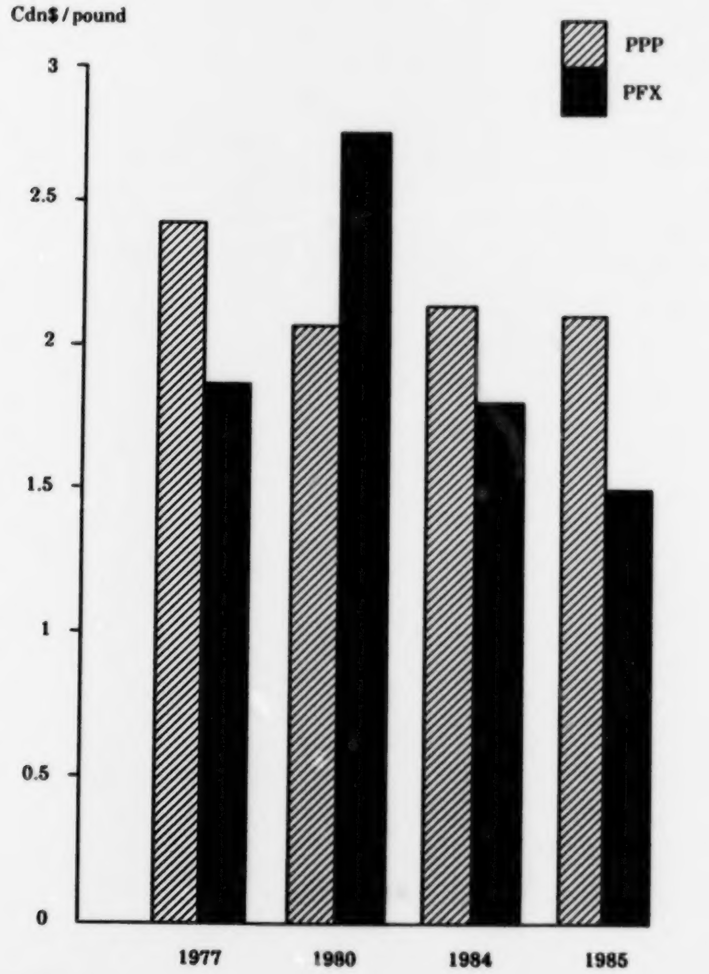
What has happened since 1973 is rather different. International differentials in real interest rates have been large and sustained. So have departures from purchasing power parity (PPP), which are illustrated in Figures 1 through 5 for the Canadian dollar and the currencies of five of our key trading partners: the United States, Japan, the United Kingdom, West Germany, and France. The PPP exchange rate reflects the number of Canadian dollars needed to purchase, in Canada, an average mix of goods and services that would cost one unit of the foreign currency if purchased in the foreign

FIGURE 1
Departures from purchasing power parity between the Canadian and US dollars



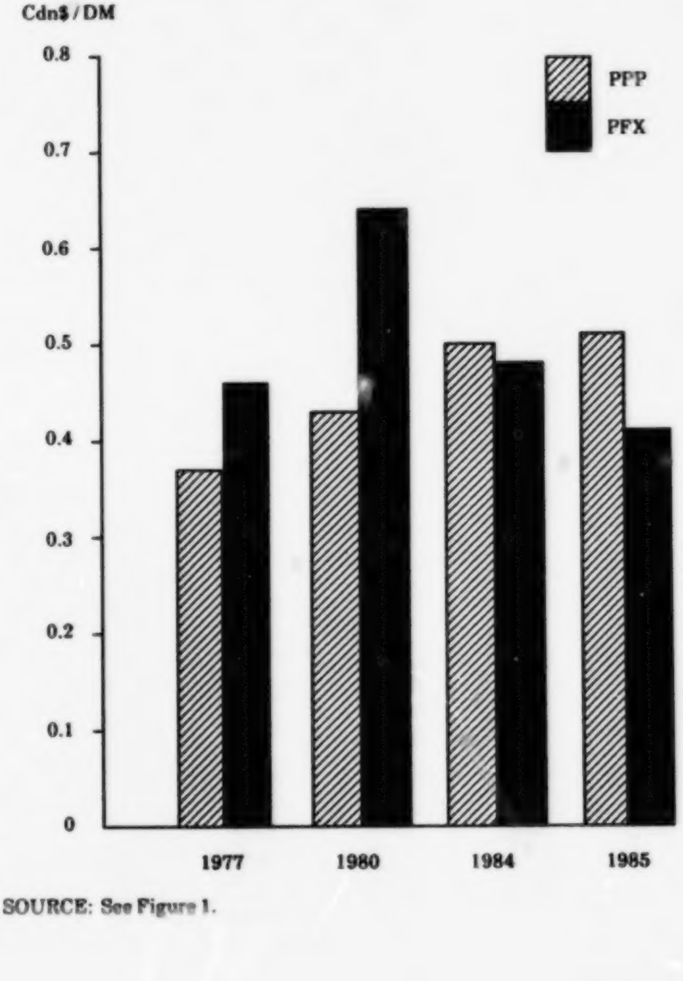
SOURCE: Data derived from Hill (1984), where the calculation methods are explained in detail.

FIGURE 2
Departures from purchasing power parity between the Canadian dollar and the pound sterling



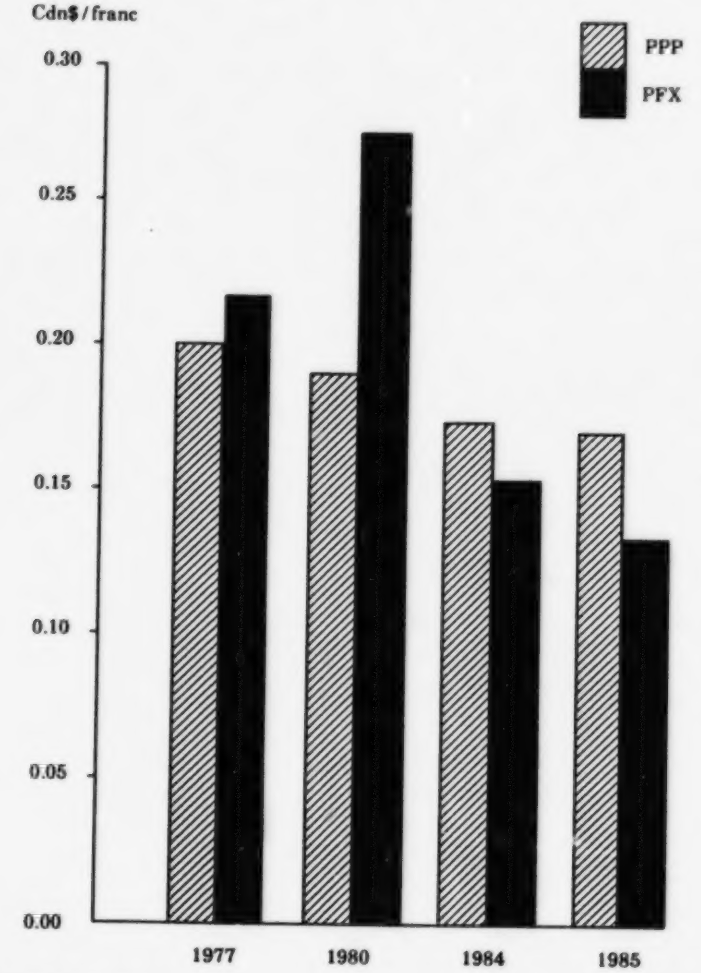
SOURCE: See Figure 1.

FIGURE 3
Departures from purchasing power parity between the Canadian dollar and the West German Deutschmark



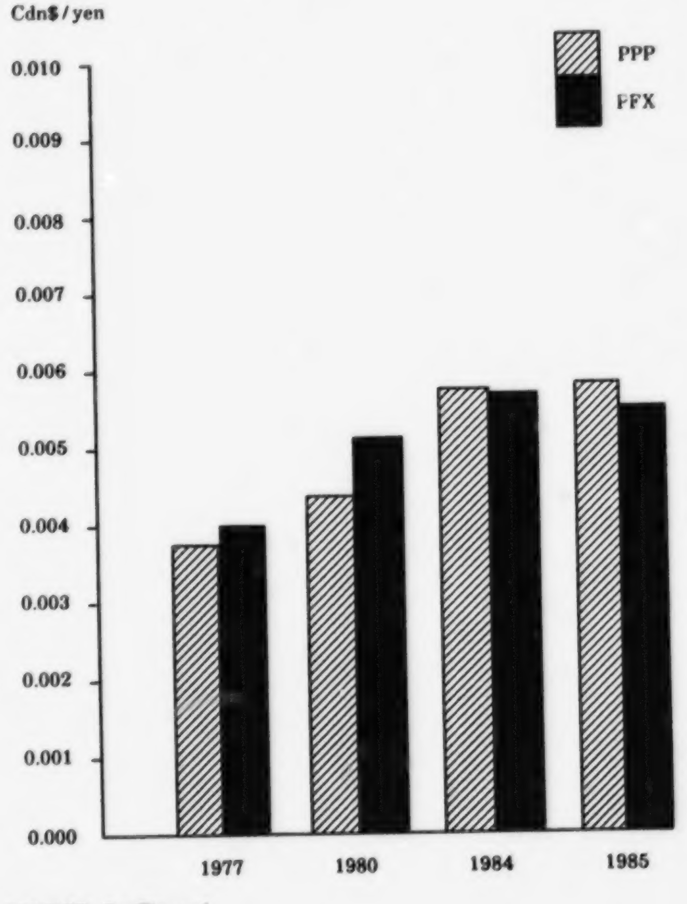
SOURCE: See Figure 1.

FIGURE 4
Departures from purchasing power parity between the Canadian dollar and the French franc



SOURCE: See Figure 1.

FIGURE 5
Measuring departures from purchasing power parity between the Canadian dollar and the Japanese yen



SOURCE: See Figure 1.

country. The rising PPP exchange rates between the Canadian dollar and the United States dollar, the West German Deutschmark, and the Japanese yen show the extent to which inflation between 1977 and 1985 has been lower in those countries than in Canada. By the same token, the falling PPP exchange rates for the UK pound and the French franc show that those countries have had higher inflation than Canada over the period.

If the market exchange rate (PFX, measuring the number of Canadian dollars required to buy one unit of the foreign currency) is less than the PPP exchange rate, then the Canadian dollar is overvalued relative to PPP; in the opposite situation, the reverse is true.[1] In 1980, for example, the Canadian dollar was undervalued, relative to PPP, against all five of the currencies shown by amounts ranging from 6 per cent for the US dollar to 33 per cent for the West German mark. Thereafter, the US dollar rose dramatically in real terms relative to all the currencies. The Canadian dollar rose almost as fast; by mid-1984, it was 13 per cent undervalued with respect to the US dollar, equal to PPP with the Japanese yen, and overvalued by 6 per cent, 12 per cent, and 19 per cent against the DM, the franc, and the pound sterling respectively. By the middle of March 1985, the situation was even more extreme, with the Canadian dollar undervalued by more than 15 per cent with respect to the US dollar, overvalued by 5 per cent, against the Japanese yen, and overvalued by 23 per cent, 26 per cent, and 40 per cent with respect to the DM, the franc, and the pound respectively.

The most striking overall feature of the evidence is the rise in the real value of the US dollar since 1980. When this evidence is combined with the fact that the US current account balance has gone from a $2 billion US surplus in 1980 to a forecast deficit of $131 billion US for 1985 (OECD 1984), the great importance of capital movements becomes starkly clear. After all, if capital were sluggishly mobile, an expenditure-based surge in activity, like that in the United States since 1982, would lead to a current-account deficit and a lower real value of the US dollar. If capital were not mobile at all, of course, the US dollar, in the absence of official intervention, would have had to fall far enough to avoid any induced current-account deficit – that is, far enough to make the prices of US export and import-competitors sufficiently attractive to offset what otherwise would be an increase in imports induced by higher US final demand for guns, butter, and VCRs.

In the absence of full and complete integration of goods markets, the value of the US dollar would have remained below its PPP value by enough to keep the current account balanced (in the case of immobile capital) or to keep the current-account deficit small enough to be financed by the available capital inflows.

What has happened, in fact, is that incipient capital inflows to the United States have been so large as to bid the US dollar well above its PPP level, so that the expenditure-induced part of the current-account deficit is augmented rather than offset by the effects of the exchange rate.[2]

Why has the US dollar appreciated?

How surprising is this state of affairs? At the risk of being simplistic, let us treat the post-1980 US experience, to the extent it differs from that of other countries, as resulting from an increase in domestic expenditures, and consider some of the econometric evidence. The effects of expenditure changes on interest rates and hence on the exchange rate depend, of course, on what monetary policy is assumed to accompany the expenditure change. If the monetary authorities expand the money supply enough to hold interest rates constant in the face of an increase in expenditures, all of the theoretical and almost all of the available empirical results show a weakening of the US dollar, partly from the additional inflation but mostly from the lack of a magnet to attract additional capital flows. That set of assumptions, however, is neither so interesting nor so applicable to the recent US experience as its opposite: the central bank holds the money supply fixed in response to the expenditure increase, letting interest rates increase as much as needed to finance the government deficit (to the extent that the expenditure increase has come from governments) and to spread around the available supply of money.

What is the evidence about the exchange-rate effects of spending increases with the money supply held fixed? For the United States, the evidence indicates that the dollar would appreciate in response to a debt-financed increase in government spending, but generally not by amounts approaching the actual post-1980 increases in its value.[3] For Canadian models, the evidence is mixed about the exchange-rate effects of an expansionary fiscal policy with the money supply fixed; some models show appreciation and others depreciation (O'Reilly and Smith 1982, 46).

The most appropriate conclusion from the available US and Canadian evidence is that interest-induced capital mobility is high enough for exchange-rate appreciation to result from an expansion in expenditures. However, the evidence does not indicate that the interest-induced appreciation would be likely to be on anything like the scale of the US dollar appreciation in recent years.

What other reasons might there be for the movements of the US dollar? Since different explanations have different implications for whether Canadian policy should follow the US dollar more closely, track some group of other currencies, or pursue a more resolutely independent monetary and exchange-rate policy, some short review of the possibilities is necessary.

One popular explanation of exchange-rate volatility (Dornbusch 1976) is that it is a consequence of unexpected changes in monetary policy coupled with continual maintenance of covered interest-rate parity between currencies. Under these assumptions, an unexpected tightening of US monetary policy would cause the forward value of the US dollar to appreciate in response to the expected reduction of the US price level, while its spot value would appreciate even more in order to maintain the interest arbitrage condition. However, the mass of evidence on movements of spot and forward exchange rates in response to changes in interest-rate differentials suggests that the forward rate moves more than the spot rate and in the reverse direction.[4] So this particular model of overshooting is not likely to be generally applicable or to explain the large and sustained departures of the US dollar from PPP.

Other possible explanations for the recent strength of the US dollar, as canvassed by the OECD (1984, 78-84) include real interest-rate differentials, increased responsiveness of capital movements to interest-rate differentials, and higher-than-expected profitability of business investment in the United States. The evidence does not really support any of these interpretations. Since 1980, the real interest-rate differential for a weighted average of other countries has been constant, while the real exchange value of the US dollar has increased by more than 30 per cent. The relative profitability of investment in the United States was higher in 1980 than it has been since, and the bulk of the increased capital inflows to the United States have been short-term banking flows.

Although the evidence is still not conclusive, the general impression it gives is that there are few fundamental economic reasons for the 1980 to 1984 increase in the relative value of the US dollar, or for its remaining as far above PPP as it is in mid-April of 1985. The period of US dollar volatility may, therefore, not be over.

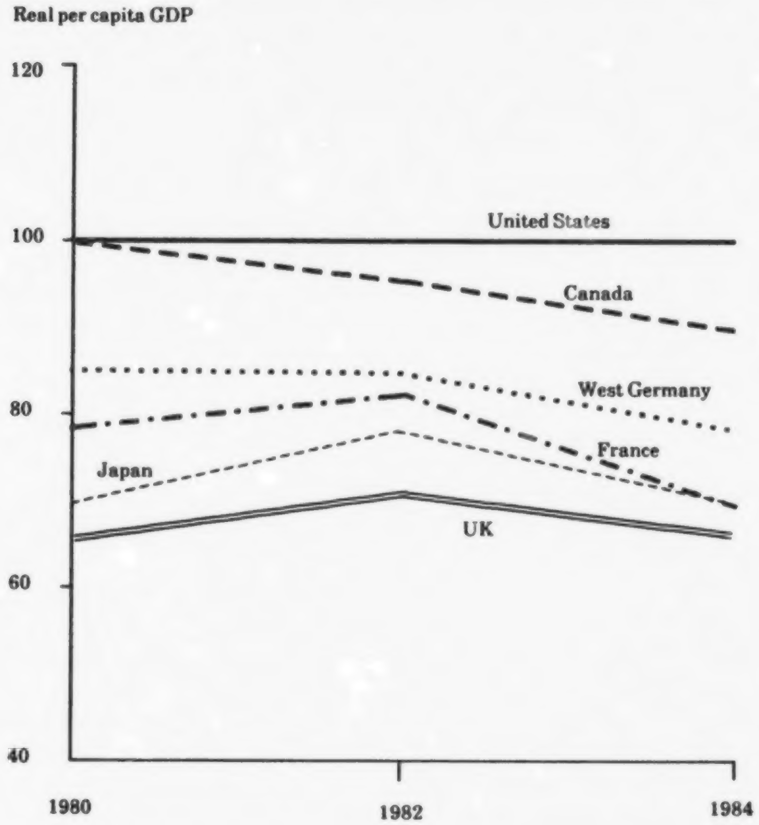
This conclusion may have implications for the choice between bilateral and multilateral orientations for Canadian macroeconomic policies.

ALTERNATIVE MACROECONOMIC POLICY STRATEGIES FOR CANADA

The issues raised in the background papers for this conference show the choices that might need to be made between bilateral and multilateral approaches to trade policy. The evidence I have assessed for this paper does not contribute directly to that question, but there is some indirect evidence in the PPP data. Once it is possible to collect reasonably comprehensive measures of absolute purchasing power equivalents in different currencies, it is then possible to use PPP exchange rates to prepare more stable and meaningful comparisons of per capita real incomes. These are useful for discussions of the consequences of trade policies since the gap between Canadian and US per capita real incomes is sometimes used to provide a rough measure of the extent to which Canadian incomes could be raised if Canada were part of a North American common market and had access to whatever economies of scale and specialization are available to US firms.

The income comparisons in Figure 6, which are based on the PPP exchange rates, show that in 1980 Canadian per capita incomes were as high as those in the United States. Although the US then had a smaller recession and a substantially faster cyclical recovery than Canada, the 1984 gap in per capita incomes was less than 10 per cent.[5] These figures suggest a much smaller gap than is obtained by using market exchange rates, which have overvalued the US dollar relative to the Canadian by increasing amounts from 1980 through early 1985. (See Figure 7, which shows the income comparisons based on market exchange rates. Figure 8 shows the incomes in Figure 7 as a percentage of those shown in Figure 6. In other words, Figure 8 shows the ratio of the PPP exchange rate to the market exchange rate and thus the ratio of the national cost of a basket of goods that is bought

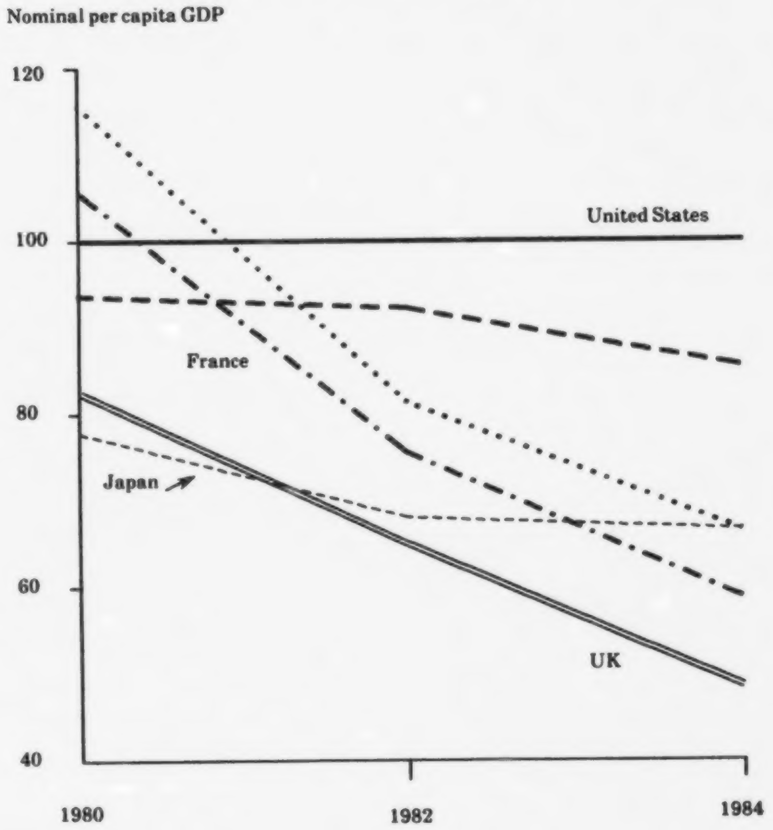
FIGURE 6
Relative per capita incomes, calculated with purchasing power parities (US = 100)



with US dollars purchased at the market exchange rate to the price of the same basket of goods purchased in the United States.)

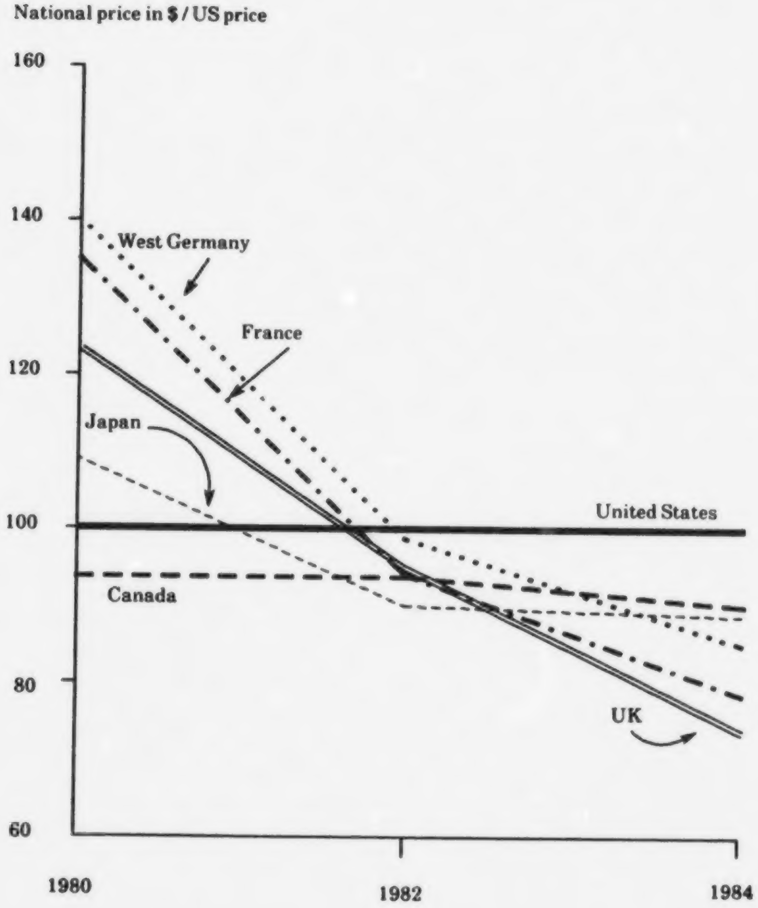
The PPP-based income comparisons suggest that substantial increases in per capita incomes may not be available from further integration of trade flows unless there is a substantial weight of other

FIGURE 7
Relative per capita incomes using market exchange rates (US = 100)



factors (resource endowments, system of government, education levels, social structures, and so on) that would yield, on balance, and given a similar industrial structure, substantially higher per capita incomes in Canada than in the United States.

FIGURE 8
Ratio of the national price level in $ to US price level



Strategic choices

Although the evidence from the PPP-based income comparison is fascinating, it is a byproduct of the main purpose of this section of the paper, which is to take the likely pattern of trade relations as given and to assess alternative macroeconomic strategies for Canada.

Richard Cooper (1984) argues that by the year 2025 the international integration provided by ever more efficient and inexpensive communications and transportation will have so increased the advantages of a unified world currency that it is now time to start thinking out the international monetary framework that would permit and foster such a result. I suspect he may be right, although it is worth pointing out that the same efficient computing power that will allow managers in Nairobi to organize production lines in Peru will also make it easier to compute and diversify the effects of changes in the exchange rates of individual national currencies.

If it is possible to leave undecided the likely or desirable twenty-year goals for the structure of the international financial system and hence for the role of independent national macroeconomic strategies, what can be said about the available strategies and tactics for the intervening period? Oversimplifying, one can delineate a three-way strategic choice for the external orientation of Canadian macroeconomic policies:

1 To become, *de facto* or *de jure*, a part of the US dollar block by linking the Canadian dollar more closely, or completely, to that currency.
2 To have a system of managed exchange-rate flexibility that mediates large real divergences between the US dollar and other important currencies.
3 To set domestic monetary and fiscal policies without regard for the real and nominal exchange rates that result.

Historical choices

Canadian policy discussions (especially press reports and commentaries on policy issues) have substantially assumed the desirability or inevitability of the first of these options. In fact, this is often common ground for those who disagree strongly about the particular macroeconomic policies that should be followed. For example, when US interest rates and the value of the US dollar both rise, there is often a debate between those who want Canadian monetary policy to tighten enough to keep our dollar from falling relative to that of the United States and hence to avoid the inflationary effects of currency depreciation and those who want an easier monetary policy and a lower Canadian dollar to obtain greater domestic income and employment. Yet both sides focus exclusively on the price of the US dollar, despite the fact that the inflationary and demand-generating effects under discussion arise from some weighted-average exchange rate for the Canadian dollar, not just from the price of the US dollar.

The widespread use of the price of the US dollar as though it were *the* relevant foreign exchange rate for Canada probably has three causes. First, during the fairly long period (before 1973) of fixed exchange rates between the US dollar and most other currencies, there was no great loss in using the US dollar exchange rate as a measure of the value of the Canadian dollar. Old habits die hard, and only in the past few years have the exchange rates between the US and the rest of the world been variable enough to disturb that comfortable simplification.

Second, there has been a shortage of easily available, more broadly based measures of the external value of the Canadian dollar. Although the OECD and the IMF have for some years published trade-weighted exchange rates, the Bank of Canada long resisted reporting any such series in the *Bank of Canada Review* and only began to do so in the latter half of 1984. Even with trade-weighted exchange rates for Canada now more widely available, they are not yet regularly used as a basis for reporting or discussion in the press. In the United Kingdom, by contrast, there is regular reporting and commentary on the trade-weighted exchange rate.

Third, regional differences within Canada may explain why Ontario-based institutions and commentators emphasize the US dollar to the exclusion of other currencies. The federal government's trade discussion paper (Kelleher 1984, tables 2 and 3) shows that while 75 per cent of Canada's merchandise exports go to the United States, this percentage varies importantly by region; it is 36 per cent in British Columbia, compared to 90 per cent in Ontario. Roughly 17 per cent of British Columbia's GDP is sold to overseas merchandise export markets, compared to less than 3 per cent for Ontario, even though the two provinces are equally dependent on total foreign trade with merchandise exports originating in each amounting to just over one-quarter of GDP. Writing at a desk overlooking Vancouver's harbour filled with ocean-going freighters, it is hard for me to consider the price of the US dollar as a suitably representative exchange rate for Canada, but I can imagine that the view from Windsor is rather different.

Given the widespread preoccupation with the US dollar exchange rate, why have actual Canadian macroeconomic policies over the last decade not kept our dollar even more closely in line with that of the United States? Oversimplifying yet again, the principal reason is that Canada's announced policy over the past decade has generally been the third of the strategies I listed, coupled with a 'leaning against the wind' policy with respect to exchange-rate changes. Although the latter policy has been defined and applied almost exclusively with respect to the Canadian/US dollar exchange rate, it has had the effect of making the Canadian dollar move in the same direction as the US dollar (when the latter has tended to move against all currencies) but not as far. In addition, it is important to recall that the Canadian dollar has, in fact, followed the US dollar much more closely than most other currencies; witness the much smaller, although still substantial, changes in the bilateral real exchange rate evidenced in Figures 1 through 8. Since the US dollar and the other major currencies have tended, over the last eight years, to move in opposite directions with respect to the Canadian dollar, the net result has been that the weighted average exchange rate for the Canadian dollar has been less volatile than either the bilateral rate with the US dollar or the bilateral rates with most other major currencies.[6]

Thus, a macroeconomic strategy that has involved an explicit domestic focus (strategy 3) has been coupled with a short-term tactic of partially resisting bilateral changes in the price of the US dollar (strategy 1) in order to produce relative stability for a trade-weighted exchange rate (strategy 2).

Future choices

Looking to the future, is the multilateral macroeconomic orientation of strategy 2 to be preferred to the bilateral orientation of strategy 1? If so, what if anything needs to be done to better implement it?

The first point to make – it is essentially a reiteration of earlier discussion – is that the issue is an important one only because there have been and are likely to continue to be substantial and sustained changes in real exchange rates beyond those required by the international adjustment process. If this analysis is correct, it suggests a second point: excessive volatility of real exchange rates may impose real adjustment costs on the externally exposed sectors of the economy, at least to the extent that they are not able to disentangle correctly, plan for, and finance the consequences of impermanent and eventually unsustainable changes in exchange rates.

If there is an efficiency case for giving macroeconomic policies some role in dampening swings in real exchange rates, the same reasoning implies that the focus of attention should be a trade-weighted exchange rate, rather than a bilateral one. It is true, as Canadian experience has shown, that action taken to offset partially the movements of an important bilateral exchange rate can also reduce movements in trade-weighted exchange rates. Yet it does so in a partial and asymmetric way and provides no reaction to exchange-rate changes that do not directly involve the bilateral rate.

All of this suggests that 'leaning against the wind', to the extent that it is used as an element in the formation of Canadian monetary policy, should be defined in terms of a weighted exchange rate rather than the bilateral exchange rate with the US dollar. The only exception seems to be if, by a sequence of bilateral trade-expansion measures, the trade of Canada with the United States grows so rapidly that the gains from adopting a common currency outweigh the benefits of a separate national currency. That point seems rather distant from the present, and even if it is reached, the situation might well be dominated by some form of common international currency of the sort discussed by Cooper (1984). One reason is that the growth of world income and trade outside North America over the next century is sure to be higher than that of the North American economies,[7] so a trade and macroeconomic strategy that is focused within North America is likely to lose its relative attractiveness as time passes.

Given the important effects that monetary policies have on exchange rates, separate national strategies of 'leaning against the wind' tend to cause national monetary policies to move together to some extent. Is there a case for policy co-ordination of a more explicit sort, perhaps for making national monetary policies and exchange rates the basis of international discussion and even negotiated agreement? At the April 1985 ministerial meeting of the OECD, some European delegations suggested the holding of such discussions of national monetary policies as a precondition for a new round of multilateral discussions on reducing tariff and nontariff barriers to trade. This suggestion puts the links between trade and macroeconomic policies in an extreme form, but it is probably an accurate reflection of a commonly held view that exchange-rate variability and the high values of US interest rates and the US dollar are as threatening to stable trade relations as are existing tariff and nontariff barriers to trade. Although it is not hard to conceive of circumstances in which internationally agreed-on national monetary policies would be generally advantageous, experience suggests that not much is likely to happen in this direction in the immediate future.

The short-term choice for Canadian macroeconomic policy is, therefore, likely to remain how best to deal with an uncertain and changing situation of external exchange rates, growth rates, and trade patterns. The evidence I have assessed suggests that some external orientation of macroeconomic policies is likely to be modestly helpful in dampening excessive changes in real exchange rates and that the trade-weighted exchange rate, rather than the bilateral one, should be the primary focus of attention.

NOTES

1 Changes in the ratio of PFX to PPP are often referred to as changes in the 'real exchange rate'. In the absence of impossibly complete integration of world markets for goods and services (it will never be feasible to travel to Bogotá just to avail oneself of cheaper haircuts), changes in the real exchange rate are a necessary part of the international adjustment process and provide the main channel for effecting international transfers of capital.

2 An analogous case under fixed exchange rates is analysed with textbook IS, LM, and BP curves; if the BP curve is flatter than the LM curve, an increase in domestic spending, represented by a rightward shift of the IS curve, gives rise to a balance-of-payments surplus and hence to an increase in foreign-exchange reserves. The equivalent under flexible exchange rates would be an appreciation of the domestic currency, as happened in the United States.

3 Under expansionary US fiscal policy, the US Federal Reserve Board's Multi-Country Model (MCM) shows appreciation of the US dollar made up of yen and DM depreciation and Canadian dollar appreciation (Stevens et al. 1984, 144). Bilateral simulations of the Federal Reserve Board's MPS model with the RDX2 model of Canada

show that a contractionary US fiscal policy, with the money supply held fixed, would weaken the US dollar (Helliwell and McRae 1977, 174). By symmetry, an expansionary US fiscal policy would lead to an appreciation of the US dollar. The Japanese EPA model simulations reported in Helliwell and Padmore (1985, 1121-4) show an appreciation of the US dollar under expansionary US fiscal policy, even with an accommodating US monetary policy.

4 The correlations are to be found in Brittain (1977), and their implications for the overshooting hypothesis are discussed in Helliwell (1979).

5 These figures relate to the whole economy, while most of the calculations of the effects of free trade deal with the manufacturing sector, which is the most sheltered by trade barriers. (Many service industries are protected more by distance, and the resource-based industries already face world markets for most of their output.) It is thus likely that potential increases in output per employee in the manufacturing sector from trade liberalization are two or three times as large as those for the economy as a whole. (I am grateful to Don Daly for suggesting this link between the aggregate and the sectoral data.)

6 Canada's most stable bilateral real exchange rate has been with respect to the Japanese yen, which has remained within 10 per cent of PPP over the last ten years.

7 This is inevitable principally because there is scope for much larger catch-up in the economic and trade growth of countries that now have per capita output levels far below the 7 per cent of the world's population living on the lands north of the Rio Grande.

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Should taxes be included in trade agreements?

Wayne R. Thirsk

Can international trade agreements that seek to liberalize trade safely ignore taxation policies? Or must effective trade agreements encompass constraints on taxation? That is the central issue addressed in this paper. Its satisfactory resolution requires a thorough understanding of how taxes can influence trade. Thus, the first part of this paper describes the numerous channels through which tax-policy choices may affect both the volume and the pattern of international trade. A second section briefly explores the links among taxation, trade, and economic welfare. In the third section, the growing importance of export subsidies and countervailing duties is discussed. A range of tax options for Canada to consider is presented in the fourth section. A short summary of major points concludes the paper.

THE IMPACT OF TAXATION ON TRADE

Trade is motivated by anything that causes relative commodity prices to vary among countries. Traditional analysis of international trade has focused on intercountry differences in resource endowments and production functions as the primary sources of relative price variation. Differences among countries' tax structures may also produce disparities in relative prices and provide an artificial stimulus to trade flows.

The provisions of the General Agreement on Tariffs and Trade draw an important distinction between direct and indirect taxes. Only the

Professor Thirsk is a member of the Department of Economics, University of Waterloo.

latter are felt to contribute in an important way to international differences in relative prices. Accordingly, the GATT allows countries to employ border tax adjustments (BTAs), which minimize (but do not entirely remove) the influence of indirect-tax policies on trade patterns. With BTAs, origin-based taxes are afforded destination-basis treatment, and indirect taxes imposed on domestic production are converted into equal-rate taxes on domestic consumption. Countries are permitted to rebate indirect taxes on exports and to impose an equal-rate tax on all imports of the item in question.[1] Thus exports are not placed at a competitive disadvantage in foreign markets, and imports are put on the same tax footing as domestically produced substitutes.

Although the distinction between the cost-raising impact of direct and of indirect taxes commands widespread support, in the eyes of some observers it is at best tenuous and at worst wholly arbitrary. What matters is not whether the tax is directly imposed on persons or indirectly on commodities but, rather, whether the tax applies to all activities in the economy or to only a few. Only a perfectly general tax, regardless of its direct or indirect nature, will not disturb the economy's structure of relative prices. For example, if a direct tax on capital or labour incomes applies only to exports or to some kinds of exports, the cost of capital or labour will rise only in those activities. Exports will be discriminated against unless remission of the direct tax is allowed. On the other hand, if the capital or labour income tax applies to the whole economy, a remission of these taxes will subsidize export activities. In the same vein, a fully general indirect tax will not alter relative price structures, so BTAs will be superfluous in a world of flexible exchange rates. With flexible rates, any increase in a general indirect tax will provoke an exchange-rate depreciation that leaves trade patterns unchanged.

In this context, it is important to consider subsidies, which are inherently selective, as negative taxes in essence. A particular sector or activity would be fiscally favoured if taxes were increased everywhere else in the economy. It is obviously much easier and more direct to reduce relative costs in the chosen sector or activity by making it a subsidy target. Under the GATT code, direct export subsidies are illegal except in the case of primary (agricultural) commodities. However, as described later in this paper, indirect or covert export subsidization is fairly common among GATT signatories.

Tariffs can be viewed as taxes on international trade, and whatever protective effects they achieve for domestic industry can be duplicated by a system of taxes and subsidies. It is well known, for example, that a tariff is equivalent to a combined tax on consumption from all sources and an equal-rate subsidy to domestic production of the taxed item. However, while tariffs determine trade volumes and can at most extinguish trade, taxes can determine the direction of trade and are thus potentially more distorting than tariffs.[2] Subsidies can stimulate domestic supplies until they are more than adequate to meet domestic demands. Taxes, on the other hand, may discourage domestic production to the point at which a commodity once sold abroad is now purchased from abroad.

The common agricultural policy (CAP) of the European Economic Community offers a vivid illustration of the ability of subsidies to disrupt trading patterns. The EEC was formerly a net importer of wheat, sugar, dairy products, beef, pork, and poultry. At present, the EEC countries are net exporters of these items to Canada and compete with Canadian exporters in third countries. This shift in the direction of trade is the result of CAP subsidies, which currently cost more than $20 billion a year; about $5.5 billion of that amount goes to direct export subsidies.

If taxation and tariff policies are close substitutes for each other, there is a legitimate fear that the trade-liberalizing effects of successive tariff cuts over the last two decades will be undermined, either in whole or in part, by compensating adjustments in tax policy. In fact, recent tariff cuts appear to have accelerated the growth of nontariff barriers to trade in general and trade-related subsidies in particular. Brean (1984) has labelled as neoprotectionism this trend towards the deployment of subsidies to exports and to import-competing domestic industries.[3] A description of some of the major neoprotectionist practices and the retaliatory measures imposed against them is deferred to the third section of this paper. Suffice it to say here that the attainment of today's freer trade has been accompanied by a rising clamour for fairer trade. The United States in particular has given urgent priority to what it refers to as 'playing on a level field', by which it means the removal of the effects of government intervention on decisions affecting international trade.[4]

Before going any further, however, it is worth noting that, despite the close connection between taxes and trade, it would be premature to conclude that securing desired trade policies necessarily requires the imposition of constraints on the conduct of tax policy.

TAXES, TRADE, AND ECONOMIC WELFARE

Because exports account for such a large proportion of Canadian GNP, it is frequently an article of faith that more trade and greater access to foreign markets are always in Canada's best interests. The danger in this line of thought is one of seeing increased trade as an end in itself, rather than as a means towards the attainment of more basic goals, such as a higher level of real income for Canadians. In discussing the merits of various trade proposals, we clearly need a welfare-oriented framework, one that identifies who gains and who loses as a result of which measures and by how much.[5] Too often the absence of such a framework leads to an inversion of the ends and means of economic policy.

There are undoubtedly circumstances under which Canada would benefit from enhanced levels of trade. If Canada participates in trade liberalization efforts, it stands to capture the lion's share of the gains from freer trade with larger price-making partners. Foreign tariffs reduce the price received by Canadian exporters so the elimination of such tariffs would improve Canada's terms of trade and raise Canadian incomes. Wonnacott and Wonnacott (1982) estimate that free trade with the United States in 1967 could have produced a gain of as much as 7.0 to 10.5 per cent of GNP. (The percentage gain today would be smaller because of the steady drift towards freer trade since then.)

It would clearly be in Canada's interests to take steps to ensure that neither domestic nor foreign tax policies undo the benefits of trade liberalization. Nevertheless, it does not follow that taxes should never operate as trade barriers or that subsidies to promote higher levels of exports are always desirable. The gains from trade are extremely sensitive to any changes in the terms of trade. Since Canada is not a price-taker in every market in which it exports, it can be argued that Canada should impose taxes on exports having very low demand-elasticities in order to improve its terms of trade and that it should avoid subsidies because they invariably worsen its terms of trade.

Another fiscal factor that bears on Canadian export performance is restrictions ('taxes') on the level of foreign investment in Canada. If investment and export sales made in Canada by foreigners are complements, a relaxation of the regulations of the Foreign Investment

Review Agency (FIRA) would increase Canadian imports and, through exchange-rate adjustments, indirectly encourage a higher level of Canadian exports. Similarly, given the same assumption, if Canadian tax laws favoured foreign over domestic investments, Canadian exports would be indirectly assisted. Although the assumption of complementarity illustrates only one possibility, the point remains that a satisfactory welfare framework must be broad enough to incorporate the effects of tax-induced factor flows as well as tax-induced commodity flows.

EXPORT SUBSIDIES AND COUNTERVAILING DUTIES

Because of their selective nature – the ease with which they can be applied to particular industries and firms – subsidies have become the universally preferred fiscal instrument for promoting exports and also for protecting import-competing activities. Subsidies can take a variety of forms, including preferential credit terms for exports, loan guarantees, favourable exchange rates, special tax concessions, tied foreign aid, tax credits, outright grants, and the provision of publicly supplied inputs at prices less than the full costs of production. Export subsidies may be either direct (and thus confined to the export activity of a firm or industry) or indirect (and thus apply to both domestic and foreign sales).

Once granted, subsidies have a tendency to gather momentum and to proliferate both within and among countries. For example, subsidies initially designed to protect import-competing industries in one country may elicit offsetting export subsidies in other countries, which in turn may provoke countervailing duties in yet other countries. With chain reactions of this kind, once subsidization gets started it is difficult to pinpoint where the process began and exactly where it will end.

The United States' Domestic International Sales Corporation (DISC), which offers tax benefits for US exports, is the reaction of that country's government to the thrust of perceived export subsidization in other countries, particularly some European countries such as France and The Netherlands, that rely on the principle of territorial taxation.[6] Under this principle, the taxes on foreign earnings are substantially less than the taxes imposed on incomes earned from domestic activities.[7] Although primarily aimed at Europe, DISC may affect Canada the most. Canadian reaction to its introduction was swift and took the form of a new manufacturing-processing allowance, which reduced corporate tax rates in the manufacturing sector.

Whether this was the most appropriate form for Canada's response is debatable. The lowering of the corporate tax rate reduced the value of the US foreign tax credit to Canada, so Canada may have succeeded only in transferring a large amount of revenue to the US treasury. An alternative and perhaps less costly response would have been to let the exchange rate undergo a modest depreciation and thereby offset the DISC threat to Canada's import-competing industries as well as to its exports in third countries.

Identifying subsidies

Subsidies give rise to problems not only of proliferation but also of identification. There are two issues to consider in this respect. One is that not all subsidies confer an unfair trade advantage. Some merely compensate for the cost-raising impact of other aspects of domestic policy. Failure to grant a subsidy in this situation either penalizes exports or encourages imports. A case in point is the Department of Regional Economic Expansion grant awarded Michelin to establish its Canadian-based operations in Nova Scotia. The United States cried foul and applied countervailing duties to the Michelin firm. The subsidy in this case actually offset a natural cost disadvantage of locating in a particular region and was thus equivalent to a rebate of a location tax on exports. Viewed in this light, the countervailing duty is a protectionist device, rather than an instrument for preserving trade neutrality. It also thwarts the goals of Canada's regional development policies.

A second, totally different issue arises from the ability of countries to disguise subsidies through the judicious manipulation of tax instruments. Suppose, for instance, that Country A wishes to subsidize its steel exports but is prevented from doing so directly by an agreement that prohibits direct export subsidies. Not to worry: the desired increase in steel exports can be brought about indirectly through the differential taxation of steel and nonsteel products. Differential taxation can work either on the supply side to shift resources towards steel or on the demand side to discourage domestic consumption of steel. Thus, Country A has several choices. It can impose an origin-based tax on nonsteel products at a rate higher than the rate for an origin-based tax on steel. Or it can apply an origin-based tax on nonsteel items and a destination-based tax on steel products. Or its destination-based tax on steel can exceed its destination-based tax on nonsteel commodities. Alternatively, it can simply subsidize the domestic consumption of nonsteel output. Any one of these policies or some combination of them can replicate the consequences of a direct subsidy to steel exports.

Destination-based taxes by themselves frequently create the illusion of an export subsidy because one can so readily observe that the domestic price exceeds the external price for the commodity in question. In this case, however, the external price has not fallen with respect to the domestic price, as would occur with an export subsidy; rather, the domestic price has risen with respect to the external price. When Canada pursued a two-price policy for wheat sales, charging domestic consumers more than the world price, an uninformed observer would have been led to the incorrect conclusion that Canada was dumping its wheat on international markets rather than taxing domestic consumers for their wheat consumption.

When private companies are alleged to be engaged in dumping, most countries respond by imposing antidumping duties. When governments subsidize exports, the response may be the imposition of countervailing duties. The Tokyo Round of the GATT reached agreement on a new code covering the application of countervailing duties against both direct export subsidies and domestic subsidies that indirectly affect exports. The Subsidies Code does not explicitly describe the range of subsidy practices that are countervailable, but countries are required to administer a test for material injury before the duty can be invoked. That is, domestic industries competing against subsidized imports must demonstrate economic harm before the countervailing duty is allowed.

According to Cooper (1978), the United States has resorted to the use of countervailing duties in situations involving direct export subsidies, compensation for export losses, multiple-exchange-rate practices, direct tax rebates, indirect tax overrebates, preferential transport rates or credit terms, price supports, and regional development subsidies, from which a significant output volume is exported to the United States.[8] Cooper also notes that a number of US government subsidies influencing exports, including the DISC program, would be countervailable under US law.

Generally, the willingness of the United States to impose a countervailing duty increased with the tax subsidy's size and the narrowness of its scope ('narrow' in the sense of how many products it applies to). Recently, it imposed duties on Canadian hog producers in response to the federal and provincial price supports for these products. In an earlier case involving Canadian lumber exports, the International Trade Administration in the United States ruled that Canadian subsidies associated with provincially levied stumpage rates are so insignificant that they do not warrant a countervailing duty.

The asymmetries of countervail practice

As far as Canadian access to US and other foreign markets is concerned, countervailing duties are subject to two important asymmetries. First, although investment subsidies to export-oriented firms are liable to be countervailed, investment subsidies granted to import-competing firms are tacitly approved. Thus Canada can countervail US-subsidized exports but not US-subsidized efforts to reduce Canadian exports through the subsidization of import-competing industry. Similarly, the United States can countervail Canadian subsidies to hog producers if they generate exports to the United States but not if they merely reduce Canadian imports of US hogs. Is one practice really worse or better than the other? As Pestieau (1978) notes, corporate bailouts by governments and other public-sector support for declining import-competing industries are also the equivalent of a tax imposed on exports from other countries.

A second asymmetry arises from the difference in the size of the trading partners and the relative importance of trade in their economies. Smaller economies are typically more reliant on external trade as a source of final demand than larger economies are. Thus a small subsidy to import-competing industry in a large economy may be much more disruptive than a large subsidy applied to a small economy's exports. In Canada's case, as it is described by Bird and Brean (1985), the high ratio of exports to total production implies that it will be difficult to avoid indirectly subsidizing exports if an industry subsidy program exists and if access to foreign markets is required in order to exploit scale economies in production.

Tax harmonization

Against a background of increasing fiscal intervention in trade relations, Canada has perhaps four broad policy options, running the gamut from tight constraints on the use of fiscal instruments to no constraints at all. All of them deserve further study and investigation.

One option would be to attempt to negotiate combined trade and tax agreements that, in addition to reducing trade barriers, also aimed at the achievement of harmonized tax policies providing for uniform fiscal treatment of producers in each country affected by the agreement.

Even if such agreements were possible to achieve, they might not be desirable since the loss of tax flexibility might be much too high a price to pay for eliminating fiscal influences on trade patterns. Tax policies could no longer be easily harnessed to serve nontrade purposes. All countries, including Canada, would be under pressure to adopt uniform revenue and subsidy systems and might be unable to satisfy their different expenditure objectives, make independent tax adjustments in light of the overall level of economic activity, or pursue alternative income-distribution policies. Tax rates could be allowed to vary across countries, since exchange rates could accommodate different tax-rate levels, but tax systems everywhere, particularly those for commodities, would have to be broadly based. And tax rates would have to be uniform within a country to avoid having an industry or sector treated differently in one country than in the others. A common subsidy policy would also have to be put in place.[9] In short, there would be an enormous loss of economic freedom to manœuvre. Thus, the costs of fiscal harmonization might easily exceed any benefits.

Harmonization might be more important *within* a country in which regions operate on a fixed exchange rate (and tax rate differentials therefore distort the pattern of resource allocation) than it is between countries that are connected by a flexible exchange rate.

It is a common perception that increasing economic interdependence and integration, such as that within the EEC, requires strong and concerted measures to harmonize different tax systems. Actually this is a misperception: little harmonization has been accomplished within this common market and, despite much discussion of and writing on the topic, no progress in that direction can be anticipated.

Income-tax systems, both corporate and personal, are likely to remain uncoordinated. Within the large free-trade area, the use of BTAs and a heavy reliance on destination-based commodity taxation have acted to reconcile the existence of disparate commodity tax systems with the desire to minimize tax-induced trade distortions.[10]

If harmonization does not take place on a formal co-operative basis, it could still occur in an informal, noncooperative manner. One view of countervailing duties is that they equalize competitive conditions that have been disturbed by one country's attempts to use fiscal policies to gain a trade advantage. In terms of the level-field metaphor, countervailing duties relevel the field after it has been tilted. Similarly, countries can match or countervail each other's export subsidies and prevent any country from gaining an advantage over the others. A system of countervailing export subsidies, however, speeds its own proliferation and, from a global perspective, is very wasteful of government revenues.

Multilateral avoidance of direct subsidies

A co-operative variant of this matching outcome, one that would avoid any revenue loss, would be a multilateral agreement foreswearing the use of direct export subsidies. It would place a brake on the tendency towards subsidy proliferation and might improve overall economic welfare. Empirical studies suggest that export subsidies may be inimical to the welfare of the subsidizing country because they cause adverse changes in the terms of trade.[11] Thus the DISC program in the United States may have helped Canada by bettering the latter's terms of trade, and a similar program in Canada might work against overall Canadian interests.

The multilateral forswearing of direct export subsidies that is proposed here would imply a willingness to tolerate indirect export subsidies that do not cause domestic and foreign prices to differ and would require a revision of the GATT rules governing the use of countervailing duties in this respect.

A potential shortcoming of this approach is that it might prove to be highly unstable because, as discussed earlier, there are so many indirect-tax avenues through which exports can be effectively subsidized. Constraints on the use of these indirect fiscal means would likely be impossible to negotiate and, even if negotiated, properly administered.

No subsidies to forestall adjustment

A third option that Canada could seek is restrictions on the use of subsidies and other devices to prop up failing import-competing industries and firms. Instead of spending to keep ailing sectors of the economy alive, countries would redirect their expenditures to facilitate the adjustment process. Canada would be able to obtain greater access to foreign markets but would have to open up its own market in some sectors, most likely in the beleaguered textile sector.

Adjustment resistance, by preventing contraction in one sector and thereby holding up expansion elsewhere in the economy, forestalls a depreciation of the subsidy-granting country's currency and thus limits its own export opportunities. In this fashion, subsidies to domestic import-competing industries can provide the same mantle of protection as tariffs or quotas do and indirectly inflict the same sort of damage to export capabilities.

Nonetheless, this option of restricting the use of subsidies is also one that contains a large measure of interference with domestic industrial policy and might therefore founder on the grounds of acceptability. For instance, would the United States have been willing to stand back and let the Chrysler Corporation go down the tubes?

No constraints on subsidies

A fourth option may have the most appeal. It consists of tolerating all kinds of subsidies, in view of the enormous practical difficulty of eradicating them. In the negotiation of trade agreements, exclusive emphasis would be placed on removing trade barriers, without any reference to tax systems.

The proposal to let the subsidies bloom rests on the proposition that it is impossible for any country either to protect or to promote everything by using tax and subsidy instruments. Fiscal favours for one group in the economy constitute disfavours for everyone else. A subsidy conferred on one sector of the economy is equivalent in every respect to a tax on all the other sectors. A uniform subsidy to all sectors of the economy will wash out through an offsetting appreciation of the country's exchange rate. For example, the EEC's common agricultural policy effectively penalizes all nonagricultural producers within the common market. Between 1973 and 1982, while the community became more self-sufficient in food and the trade deficit in agricultural products fell, the overall deficit rose from $4.2 billion to about $37 billion.

Under this option, export subsidies, to the extent they were used in one country, would provoke an appreciation of the exchange rate and thus a higher volume of imports in that country and improved export opportunities for the rest of the world. Although the subsidies would impinge on particular sectors of the economy, in doing so they would open up trade opportunities elsewhere. In short, there would be no aggregate impacts of subsidies, only selective effects that would alter the composition of economic activity.

One caveat is necessary here. This option pays little or no heed to adjustment costs, which inevitably increase with the rapidity of shifts in the targets of subsidization. Mutual gains could be obtained through international agreements to phase in new subsidy arrangements gradually. Alternatively, some sort of subsidy early warning system might be desirable.

The enormous advantage of this option is that it would largely unhinge tax policy from trade policy and free tax policy to pursue goals other than obtaining better trading relationships. In terms of the level-field metaphor, this option recognizes the impossibility of levelling the field but claims that it is still playable. The field slopes from side to side, rather than from end to end; as a result, although a particular player may be at a disadvantage during part of the game, his team faces no overall handicap in comparison with the other team. Although the competition may not be fair in every instance, the game as a whole cannot be considered inequitable.

CONCLUSIONS

The major points raised in this paper have included the following:

- To the extent that they influence the pattern of relative prices in a country, taxes are a factor in determining both the volume and the direction of trade.

- Subsidies, which are negative taxes, have become the most frequently used fiscal instrument in influencing trade flows because of the relative ease with which they can be targeted to particular activities.

- Subsidies breed further subsidies as countries react to each other's attempts to employ them to gain some kind of competitive edge. The achievement of freer trade in recent years has been accompanied by a growing demand for fairer trade.

- Effective export subsidies favouring particular activities in the economy can be structured in a number of ways. International agreements that control or eliminate only some forms that a subsidy may take always prove ineffective.

- To ensure greater access to foreign markets, Canada should be more concerned with subsidies to import-competing industries both at home and abroad than with subsidies to exports.

- International tax-harmonization agreements would be extremely difficult to negotiate and administer. Even if they could be realized, such agreements would inevitably entail a large sacrifice of freedom to make domestic policy.

- Although one country's export subsidies can be a nuisance to the rest of the world, they also indirectly make that country's nonsubsidized sectors more vulnerable to imports so it can never obtain an aggregate trade advantage. For this reason, subsidization policies may not be a serious problem as long as they are stable or change very slowly and do not impose adjustment costs on other countries.

NOTES

1 Provincial retail sales taxes automatically provide destination-basis treatment, but the federal manufacturers' sales tax is origin-based and requires BTAs in order to receive a disposition consistent with the destination principle.

2 This theme is emphasized in the work of Melvin (1975).

3 Brean (1984) also discusses the panoply of neoprotectionist measures that have evolved in a number of major trading nations. Specific examples can be found in Mutti (1982).

4 In his paper in this volume, Abraham Rotstein stresses the importance of the level-field paradigm in interpreting current US policy initiatives.

5 Although it was intended only to stimulate discussion, the recent government of Canada paper, *How to Secure and Enhance Canadian Access to Export Markets* (Kelleher 1984), is remarkably weak in this respect.

6 The origins of the DISC program are discussed in greater detail by

Horst (1977). DISC provides for a deferral of corporate-income-tax liability on income generated by exports. In 1976, the GATT Council found DISC to be a direct export subsidy, contravening the GATT. The Federal Sales Corporation (FSC) is the current legislative embodiment of DISC.

7 Territorial taxation, which is consistent with the goal of capital-import neutrality, means that income is taxed only where it is earned and not at all in the jurisdiction where the income-earning corporation resides. As a result of this practice, many French and Dutch companies use transfer pricing to allocate the bulk of their export income to tax-haven affiliates and thus pay little or no tax on it.

8 Cooper (1978) also points out that the use of countervailing duties in the United States has accelerated during the last decade and a half. From 1897, when countervailing duties were introduced, until 1957, they were imposed only forty-one times; between 1959 and 1967, none were imposed. With the current overvaluation of the US dollar (by as much as 30 per cent according to some estimates), there will be growing pressure on the US government to use countervailing duties as a method of combating the large and growing US trade deficit.

9 An example of a common subsidy front is the agreement by the Organisation for Economic Co-operation and Development to establish a floor beneath which interest rates on export-related financing cannot fall.

10 As far as noncommodity taxes are concerned, the corporate income tax is probably the most important. Because of exchange-rate adjustments, it does not matter much if one country has a higher corporate tax rate than another. What matters much more is the dispersion of corporate tax rates within each country. Thus, if one country has a higher corporate tax rate than another, its exports from sectors with higher-than-average rates are impaired, while its exports from sectors with below-average rates are encouraged.

11 Mutti and Grubert (1982) indicate that the gains to the United States from the greater use of capital in that country failed to erase the terms-of-trade loss. On balance, US welfare fell by about one-half of the revenue cost of the DISC program.

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Discussion

DON McIVER: (Sun Life): I'd like to touch on the issue of exchange rates. Suppose a free- trade agreement were in place and Canada used differential interest rates to run a monetary policy different from the

United States'. Would there be any difference between that and an export subsidy? If the answer is no, is there any way of negotiating an advance agreement as to how to harmonize monetary policy.

JOHN HELLIWELL (University of British Columbia): The link between monetary policy and trade policy is widely perceived as tight. Indeed, the ministers of a number of European countries are trying to insist on some collaboration on monetary policies as a precondition for going into new multilateral trade negotiations.

If different monetary policies didn't give rise to different real exchange rates, each country could choose its own inflation rate and everything else would wash out. In fact, we know that monetary policies do create real exchange-rate differentials, which put pressures on the tradable-goods sectors of other countries. But the effects are not the same as those of an export subsidy. A subsidy affects just one industry, while exchange rates affect everybody who purchases foreign currencies. In principle, I can't see why negotiations on monetary co-ordination would have to take place in the same framework as trade negotiations. I think they are separable in structure and strategy. However, those who feel themselves hurt by another country's monetary policy – say, the Europeans with respect to the United States – might want to pair the issues in bargaining.

I expect that Dick Cooper will have something to say about this because he'd like to see a gradual evolution to a world monetary unit. But I suspect that any international agreement about co-ordinated monetary policy is more likely to be bilateral then multilateral.

WAYNE THIRSK (University of Waterloo): I don't have much to add except to reiterate the essential distinction between export subsidies and exchange-rate movements: export subsidies tend to have a highly selective impact, whereas exchange-rate movements not only affect the whole spectrum of export opportunities but also change incentives in import-competing sectors of the economy.

MURRAY SMITH (C.D. Howe Institute): I take it from a point Professor Helliwell made in passing that Canada would not be interested in a currency union with the United States, even in the unlikely event that the bilateral trade share did get to 100 per cent, as Dr McNiven projected this morning. Is the fact that Canadian and US terms of trade frequently - perhaps systematically - go in the opposite direction a reason to keep our exchange rates outside any system monetary co-ordination?

JOHN HELLIWELL: If 100 per cent of our trade share went to the United States, the only exchange rate that would matter would be that with the US dollar.

MURRAY SMITH: Other exchange rates would still have an effect on the Canadian economy though because commodity prices for our exports would still be determined by world markets. Furthermore, we face competition in the US market from third countries.

JOHN HELLIWELL: I guess the quick answer to that is that the bilateral trade share can't really go to 100 per cent. The argument I was making was that, short of going to a common currency, a multilateral orientation would be preferable. The United States is becoming a more open economy and Canada not less open. If we had more bilateral trade, Canada's total trade would rise, and the proportion of it that went to offshore markets would drop. But the offshore share as a proportion of GDP, which is the right way of measuring openness to offshore markets, would continue to rise as the world trading system opened up.

MURRAY SMITH: Continuing on the rather complicated issue of trying to harmonize tax and subsidy policies, when I was at a conference a couple of weeks ago dealing with US trade policy, Max Corden made a proposal similar to yours: that countries should be free to do what they like in terms of domestic subsidy policy. That idea was not well received by the US economists present.

I think, however, we should distinguish broad differences in tax systems that occur among a lot of the different countries all over the world, differences that largely do come out in the wash in international trade, from those very specific tax and subsidy policies that affect particular sectors. These are the types of subsidies that have attracted countervailing duties in the United States. I think it's important to distinguish between those two types of taxes and subsidies. Is that your position, Professor Thirsk?

WAYNE THIRSK: Well, mine is a fairly complicated argument. First, direct export subsidies, those that differentiate between export sales and domestic sales, can be very disruptive and often call forth retaliation from trading partners. Therefore, it makes sense to negotiate restrictions on a country's ability to use them. On the other hand, in the case of a country such as Canada, which is heavily reliant on trade, it becomes very difficult to distinguish between what is an export subsidy and what isn't. Whatever we do in industrial policy inevitably has some impact on exports. So indirect subsidies can be construed as direct export subsidies, and thus the United States is able to apply countervailing duties. That situation is harmful to Canada's interests.

Since it's so difficult to make the distinction, given the basic asymmetry of the Canadian and US economies, I'm driven towards the conclusion that we should negotiate for toleration of all kinds of subsidies and let the exchange rate pick up the slack.

Microeconomic performance: interrelations between trade and industrial policies

Donald J. Daly

It is crucial for a relatively small, open economy (as Canada has increasingly become) that its domestic microeconomic policies be broadly consistent with its international economic policies. It is also crucial that both its commercial and its industrial policies be based on a full and realistic appraisal of how its manufacturing has been performing, both historically and currently, in an international environment that has changed significantly over the last three or four decades. The aim of this paper is to summarize the evidence and the issues on these two topics for Canada and to do so within the constraints of time and length that are appropriate to a two-day conference.

The material is presented in five major sections. The section on gains to Canada from improved market access reviews empirical studies for Canada and the appropriateness of their key assumptions. The section on microeconomic problems in manufacturing reviews some of the evidence on the competitive performance of Canadian manufacturing from an international perspective, a topic that is crucial to assessing the extent and direction of the adjustment process that is already underway in domestic manufacturing. This process is not yet complete whether further reductions in tariff and nontariff barriers are made or not. The evidence suggests that serious problems of high cost and low productivity have persisted in Canada in the early 1980s in relation to the other major industrialized countries that dominate our trade in manufactured products. These problems appear for

Professor Daly teaches economics in the Faculty of Administrative Studies, York University.

measures of costs at the prevailing exchange rates. In addition, since 1974, real wages per hour in Canada have increased relative to those in the United States, while real output per hour has slipped further behind that of the United States and Japan. Public discussion and public policy have not given this evidence and its implications the attention that it has long deserved.

The third section reviews the evidence on the costs of a protectionist response to these and other problems. The fourth section discusses industrial strategy, a response that is often associated with the retention of (or an increase in) protection and a more active policy of governmental direction for micro decision-making. The next section summarizes some of the evidence on current responses in private Canadian manufacturing, such as increased specialization, longer production runs, and the allocation of an increasing share of production to export markets.

The conclusion offers some suggestions on policies that would encourage, rather than thwart and stifle, the adjustments that are already under way.

GAINS TO CANADA FROM IMPROVED MARKET ACCESS

A series of studies have assessed the potential gains to Canada from reductions of tariff and nontariff barriers to trade. These have looked at the possible gains from freer trade with the United States and also the probable outcomes of a variety of commercial-policy options involving other countries. The estimates that I regard as the most reliable and most consistent with the microeconomic evidence summarized in this paper show gains of about 5 to 10 per cent of Canadian real GNP resulting from complete free trade with the United States alone at the start of the Tokyo Round reductions (Wonnacott and Wonnacott 1967; 1982; Wonnacott 1975, 173-87; Harris and Cox 1983, 94-5[1]). These estimates are much higher than those of the costs of tariffs for other countries. The size of the gains for Canada come about for three reasons essentially:

1 These estimates are based on the assumption of the availability of significant economies of scale at the level of the individual firm, which cannot be taken advantage of as long as high costs preclude the sale of larger outputs at profitable prices. Essentially, the companies are facing a marginal-revenue curve that is more inelastic than their

marginal-cost curve, even though, as they are largely aware, their long-run marginal costs are also falling, but slowly. This recognition of the interrelations between tariffs and productivity levels is an important contribution by Canadian economists that has not had the recognition internationally (especially in the United States) that I think it deserves.

2 The estimates reflect the fact that imports of manufactured products are larger in relation to GNP in Canada than in many other countries, so the gains could be relatively larger.

3 The estimates by Ron and Paul Wonnacott (1967; 1982) allow for a recovery of the duty now paid to the US government on the imports of Canadian manufactured goods. At present, when the prices of exports to the United States are primarily determined in the larger US market, the price received by Canadian exporters is reduced by the extent of the US tariff. Its elimination would permit an increase in the prices received by Canadian manufacturers; this is part of the real-income gain allowed for in the estimates.

Lower estimates of the gains to Canada from freer trade have been made by other researchers, some of them using input-output models (Postner 1975; Boadway and Treddenick 1977; Dauphin 1978, 72-7; Williams 1976). A serious flaw in a number of these studies is that they retain the *same* input-output co-efficients and the *same* production conditions for Canadian manufacturing with and without a tariff. In effect, they ignore the evidence and the reasoning that tariffs *do* affect production conditions within Canadian manufacturing, that lower tariffs would permit companies to take advantage of the known economies of scale, and that an enlarged market would permit a matching of lower costs per unit and larger sales.

These comments are in line with my earlier research findings (with a number of different collaborators) that lower trade barriers would lead to large gains in real income to Canadian workers and consumers.[2] Improved trade access to other countries and lower tariff and nontariff barriers in Canada are necessary to improving real incomes, economic growth, and employment levels in Canada. However, I hasten to add that further changes in commercial policy are not a *sufficient* condition for radically improved performance in Canadian exports of manufactured products.

The essential persisting problem is that the key costs of production of manufactured products are still significantly higher in Canada than in other countries. For example, as we shall see later in this paper, I put unit labour costs for total manufacturing in Canada for 1983 roughly 30 per cent higher than those of the United States; the inclusion of such costs as fixed capital, depreciation charges, and inventories would make the discrepancy even greater for total costs. Unit labour costs in relation to those of Japan are even more out of line; that country's real output per hour is ahead of Canada's (about halfway between Canada's and the United States'), while its compensation per hour (after including bonuses and all other payroll-related costs and benefits) is about 40 per cent less than Canada's. Although these data are not perfect, they are not misleading in terms of broad trends and levels. They are, of course, totals for manufacturing; Canada has some industries with high productivity levels that are internationally competitive, but they are pulled down by the existence of many more industries that are not in as favourable a position.

Further significant changes at the level of the individual firm and industry within Canadian manufacturing are necessary before the full benefits of improved trade access can be achieved. (Some of the changes now underway are discussed later in this paper.)

One other point deserves comment. Exchange-rate changes are of key importance to the whole process of international competitiveness. Between 1974 and January 1985, the Canadian dollar depreciated by almost 30 per cent in US funds. The magnitude of this change is huge compared both to the tariff changes that are taking place under the Tokyo Round and to the remaining Canadian tariffs. There have been far more studies of the effects of changes in tariff policies in Canada than of exchange rates, which have not had the attention they deserve. This was reflected in the background papers for the National Economic Conference in March 1985; five were on trade but not a single one on exchange-rate policies.

MICROECONOMIC PROBLEMS IN MANUFACTURING

The last section summarized the evidence on the huge gains freer trade could bring Canada in terms of increases in both real GNP for the overall economy and real output in manufacturing relative to labour and capital inputs. As I noted, however, improved market access is not a sufficient condition for improved performance on international trade, real incomes, and employment levels.

A fundamental and persisting problem in Canadian manufacturing is that for a wide range of industries (including agriculture), domestic producers are high-cost producers by international standards. Unless these problems are recognized and dealt with by business, labour, and government, reductions in tariff and nontariff barriers could lead to further losses of market share in both world and domestic markets and to continuing high unemployment. (Such a pessimistic outcome is not, of course, a foregone conclusion, and there are indications that appropriate adjustments have already begun at the corporate level. The evidence on this point is summarized later; here the aim of the paper is to summarize the evidence that significant further adjustments in manufacturing are necessary to take full advantage of improved market access.)

The general direction of the required adjustments is essentially similar whether one is considering freer trade only with the United States or a much larger multilateral change under the GATT negotiating framework. Since a major part of Canadian trade is with the United States, most of the potential gains would accrue from bilateral arrangements there; for a variety of economic and political reasons, however, the multilateral route would be the preferable one, though a bilateral arrangement with the United States would be a good second best – that is, preferable to the status quo.

Unit costs

Although this paper concentrates on the micro aspects of Canada's international trade (other papers in this volume deal with the macro aspects), I must be explicit about the macro assumptions that I am retaining to simplify the discussion. For the time being, I assume that international differences in wage rates, real output per hour, and exchange rates are largely maintained at 1983 levels.

Given the 1983 macroeconomic and policy environment, the fundamental problem for Canadian manufacturing is that Canada is, on average, one of the highest-cost producers of manufactured products among the major industrialized countries. This evidence on this point is summarized in Table 1. International trade in manufactured products with the countries listed there amounts to about 90 per cent of all Canada's two-way flow of trade in manufactured products, so the

TABLE 1
Unit labour costs in manufacturing, 1980 and 1983 (US = 100)

	1980	1983
United Kingdom	198.2	135.9
Canada	118.3	129.2
Italy	132.5	107.1
Belgium (1982)	179.9	106.2
United States	100.0	100.0
Sweden	166.3	95.5
West Germany	135.6	92.2
France	130.8	86.5
Japan	75.2	61.2

SOURCE: Based on indices of total compensation per hour (in US dollars converted at prevailing exchange rates) divided by indices of output per hour. For a full description of methods and sources and data for other years, see Daly and MacCharles (forthcoming), plus unpublished appendices, York University, 1984, appendix 2.

evidence is comprehensive. As the table shows, Canadian unit labour costs were about 30 per cent higher than those of the United States in 1983 and roughly double the Japanese level. In 1980, many of the European countries had unit labour costs well above the Canadian, but the dramatic and widespread exchange-rate depreciations for their currencies brought most of them below the Canadian level by 1983. The declines in sterling since then have been so large that it is expected that the next update of this table for 1984 will bring the United Kingdom below Canada and leave Canada the highest-cost producer of manufactured products in this important group of countries.

A number of questions are frequently asked about my results and the implications of the data for past and future performance. The material in Table 1 relates to unit labour costs – essentially, the average total-compensation cost of producing an average unit of output. Labour compensation is the dominant factor since it is about 60 to 70 per cent of total costs for gross domestic product in manufacturing, (excluding purchases of intermediate components and materials between plants and firms). Partial estimates of other factor costs can be made for the United States and Japan, Canada's two most important trading partners. In comparison to either, Canada has larger inputs of depreciation, capital stock, and inventories in relation to output, as well as higher nominal interest rates. If these other costs were included to make a measure of total factor cost per unit of output, the differences among countries would be even greater than those shown in Table 1 for unit labour cost alone.

The material in Table 1 is based on data for real output per hour for individual industries on a base year adjusted forward to 1983 (and adjusted to intervening and earlier years in Daly and MacCharles [forthcoming] the study from which these figures are drawn). In the base period, there was a significant variation around the mean for individual industries, with some manufacturing industries having higher levels of output per hour in Canada than in the United States. The data are thus consistent with some Canadian industries and firms (such as plywood, primary steel, and automotive assembly), being fully competitive with those of the United States, while others are clearly not. Some Canadian firms are thus active exporters, but they are still the exception, and in total a large net trade deficit in manufactured products persists for Canada.

This pattern of lower output per hour and higher costs in Canada than in the United States has been documented in studies done independently and intermittently since the 1930s. One might ask that if this situation is long standing, why is it more serious in the 1980s than it was in the 1950s, when the Canada/US cost comparison was not too dissimilar from what it is today. There are essentially two reasons, both relating to the broader world environment for international trade in manufactured products. First, the levels of nominal and effective tariff rates were much higher historically than they now are, providing a degree of protection that is now diminished and will be reduced slightly more by the Tokyo Round cuts that are still in the process of being implemented. Second, in the earlier postwar years, there was a significant degree of demand pressure against worldwide capacity, so even high-cost producers could sell on a selective basis if they had the output available. With a much more competitive world environment, underutilization of worldwide manufacturing capacity, and an increase in the developing countries' output of selective labour-intensive products, this situation has changed. Why should importers in other countries buy from a high-cost source of supply when lower-cost sources are available? These developments mean that a Canada/US cost differential that is now similar to that of the 1950s has much more serious implications than it did at that time.

This high-cost, low-productivity problem in manufacturing has led to a large net trade deficit in manufactured products but *not* to an overall current account deficit on the balance of payments in the period of recovery since the 1981-2 recession. Several factors have contributed to this phenomenon. For one thing, Canada's comparative advantage continues in natural resources, and large net trade surpluses in these products tend to offset its deficits in manufactured products, as they have historically. In addition, the period since 1980 has seen the development of a gap in real income that is probably unprecedented in the present century. The United States has had a strong real-income growth that has facilitated exports from Canada and other countries; the sluggish Canadian performance, on the other hand, has depressed Canadian imports. This pronounced difference is particularly reflected in the area of automotive products. These developments have contributed to a current account balance in total for Canada in spite of its problems of competitiveness in manufacturing.

Real wages and output

So far I have emphasized unit-cost comparisons, but the same problems show up in comparisons of real measures, such as real wages per hour and real output per hour. Since 1974, real wages per hour in Canadian manufacturing have increased relative to those in the United States, while the gap in real output per hour has widened. The divergence comes to about 15 percentage points over the decade. Part of the gain in real wages has had to come out of corporate profits. And since corporate profits after taxes are such a small part of GDP in manufacturing, this erosion of corporate profits has a significant impact on Canadian economic performance, as is discussed later.

The changes in output per hour and real wages per hour in Japanese manufacturing have contrasted dramatically with those in North America since the early 1970s. Between 1973 and 1983, real output per hour in Japan almost doubled, while the increase in real wages was only about one-fifth. Corporate profit per unit of output in Japanese manufacturing did not change appreciably over the decade, and it remained a small share of GDP in Japanese manufacturing, as it did in the United States. A major part of the productivity increase in Japanese manufacturing over the last decade has gone to benefit the buyers of manufactured products, both domestically and internationally. This has permitted a drop in the Japanese terms of trade (reflecting lower prices of manufactured products in the country's exports, while its imports are dominated by petroleum, metals, and other natural resource products). This shift is unique among the industrialized countries.

This pattern of pricing and the related distribution of the productivity gains has permitted Japan to obtain an increased share of the rapidly growing world market for manufactured products, a development that, in turn, has contributed to its low unemployment rates. These developments have a long history; comparable patterns can be observed in Japan as far back as the First World War (see Daly 1980a, b; 1984c).

The evidence on the differing levels and trends of real wages and real productivity also suggests that the recent debates about real-wage unemployment in Europe could be relevant to Canada. Edmond Malinvaud (1977; 1980; 1982) and others have explored the theory that real wages can become too high relative to the marginal productivity levels of real output, leading to lower profit rates and thus to less investment and high unemployment.[3]

Other economic indicators

The evidence summarized so far strongly suggests that Canadian manufacturing is in a condition of disequilibrium with respect both to current international cost comparisons in money terms (at current wage and exchange rates) and to real wage levels (with prevailing differences in real output per hour). If this evidence and the theories on which the comparisons are based are broadly correct, the disequilibrium should be reflected in four other indicators of Canada's economic performance: (1) its world market share of manufactured products; (2) profits and investment on durable physical assets within the country; (3) unemployment rates; and (4) international investment flows.

The evidence on each of these is summarized briefly.

World market share

Since the Second World War, trade in manufactured products has been the most rapidly growing area of world trade. At the end of the war, the United States and Canada were in a good position in world trade, with plant capacity undamaged by the hostilities and levels of manufacturing productivity well above contemporary levels in Europe and Japan. Some decline in their market shares was to be expected with the restoration of capital facilities, the check to the postwar inflation in some of the countries, increased capital investment, and improved productivity from the adoption of new technology (much of which was initially developed in the United States).

One US study (Scott and Lodge 1984, especially chaps. 1 and 2) provides evidence that the loss in market shares has been widespread and that it has not been limited to the mature industries of steel and cars but has also occurred in such 'high-tech' areas as telecommunications, pharmaceuticals, consumer electronics, electrical machinery, and watches. On the other hand, competition from Japan and the newly industrialized countries (South Korea, Taiwan, Thailand, the Philippines, and Malaysia, for example) has not been limited to such labour-intensive products as textiles and shoes but has extended into some of the high-tech and knowledge-intensive industries. It has also been established that it is not too difficult to transfer sophisticated technology to the countries of Eastern Europe and Asia, especially if some assistance in the form of training is provided in the early stages of the transfer (see Baranson 1978a, b).

Many of these same symptoms of falling market share for US manufactured products are apparent for Canadian goods also, despite increases in manufactures' share of Canadian exports and trade's share of Canadian GNP. These latter developments are sometimes overemphasized when the Canadian economy is looked at in isolation. Part of the positive developments on exports reflect the increased sales of assembled cars and trucks and associated original-equipment components under the Canada/US automotive agreement.

The drop in market share in nonautomotive manufactured products is even more widespread than the drop in total manufactured products (D'Cruz and Fleck 1985; Canada 1985a, 7; 1985b). If producers in other countries are gaining world market shares and their domestic markets are also growing, they can move down their long-run declining cost curves for individual products more rapidly than the producers in Canada. This can lead to continued or increased pressures on our domestic manufacturers for a prolonged period, even if our macro policies are broadly appropriate.

That Canadian exports' share of world trade is falling off at the same time imports are getting an increased share of the domestic market partly reflects the increased two-way flow of trade in manufactured products that has been under way in most of the industrialized countries over the postwar period. This reflects increases in specialization and in intraindustry trade (see Grubel and Lloyd 1975; Lermer 1973; MacCharles 1984).

Profits and investment

If unit labour costs in Canada are high by international standards and increases in real wages have moved ahead of increases in real productivity, one would expect corporate profits to be squeezed. Empirical analysis of the hypothesis is complicated by the fact that corporate profits reported for tax purposes have tended to be overstated in the 1970s and 1980s, compared to the 1950s and 1960s partly because depreciation allowances on plant and equipment are based on historic costs, not on current replacement costs. If corporate profits are recalculated using current replacement costs for the value and depreciation of assets, Canadian total rates of return drop in 1981 and 1982 to the lowest levels in fifty years.

These inflation-adjusted rates of return are so low that the internal cash flow to companies has been insufficient to finance the level of reinvestment in manufacturing that had prevailed in earlier years. In addition, the rate of return (including both interest payments and adjusted profits) on assets has dropped below the long-term costs of new corporate funding. The divergence was particularly large in Canada in the early 1980s – and larger than that in the United States (Daly 1984a; forthcoming). This makes it more attractive for some companies to put any internal funds into investments in financial markets (or debt repayment) rather than into new investment in machinery and equipment.

With low rates of return on physical assets, low rates of capacity utilization, and high nominal rates of interest, it is not surprising that investment in capital facilities fell in response to the 1981-2 recession and that it has remained hesitant even though the recovery has now been under way almost two and a half years.

The Canadian/US divergence of movement in business investment has been without precedent in the postwar business cycles of North America. This divergence has been widely recognized. For example, the Department of Finance discussion paper of 8 November 1984 has a chart comparing real business investment in the two countries from 1979 to 1984 by quarters; it shows a larger drop in Canada beginning in 1981 and a slower, smaller pick-up beginning in 1983 (Canada 1984, 36).[4] However, although the paper notes the existence of operating ratios that were low in relation to capacity, it emphasizes high interest rates associated with large budget deficits as a key factor in the hesitant economic growth. (There are some twenty references to interest-rate developments in the first twenty-two pages).

The emphasis on large budget deficits and high interest rates as crowding out private investment would get support from many macroeconomists (especially those close to the monetarist views on the interest-rate sensitivity of investment). However, there are a number of reasons to be skeptical of something close to a single-factor theory of business-investment sluggishness in Canada in the mid-1980s, especially for manufacturing. First, a very thorough study by Paul Evans (1985) of the effects of large budget deficits on high interest rates in the United States suggests that this explanation is inadequate; in the three periods of US history when the federal deficit exceeded 10 per cent of national income (the US Civil War and the First and Second World Wars), the evidence does not show a positive association between deficits and interest rates. Second, the available evidence indicates that interest rates have had only a minor influence on business investment in the past, although both interest rates and the availability of mortgage funds have had and continue to have significant influence on the construction of apartments and condominiums as well as individual homes (Daly 1984b; 1966). Third, long-term nominal interest rates in the United States and Canada have moved very much in line with each other over the last half-dozen years, so interest rates cannot be a factor in the dramatic contrast between the two countries' performances in real business investment in the same period. Fourth, the Department of Finance paper (Canada 1984) largely ignores the whole question of international competitiveness in manufacturing, an area that is central to the interpretation of this paper and the larger research work on which it is based. The paper has several incidental references to price competitiveness in manufacturing but no comprehensive discussion or intercountry comparisons of levels of unit labour costs and real output per hour or of the tendency for real wages and real output per hour in

Canadian manufacturing to get out of line relative to those of our two most important competitors – the United States and Japan. Such an omission is serious since salaries and wages in manufacturing are almost *ten times* as large as interest rates, which the Department of Finance does emphasize. The high-cost and low-productivity aspects of performance are far more important than differences in interest rates in Canada's relative weakness in business investment.

Economic performance and unemployment

When unit labour costs and real wages get out of line internationally in an industrial sector as important as manufacturing in a small, open economy, the resulting problems can be serious. The total rates of return to capital can be significantly eroded because firms can retain market share in both world and domestic markets only by attempting to be price competitive.

Domestic costs in Canada are high; many producers in the United States and Japan have had lower costs for most of the last decade or two. Furthermore, the drops in many of the European currencies since 1980 have brought many of them from having unit costs higher than Canada's to having lower ones in 1983 and 1984. When profits are a small part of total income in manufacturing, as they are in Canada, any squeeze between high domestic costs and low international prices can be very severe.

The severity of the recession and the sluggish nature of recovery have combined with these longer-term cost problems to contribute to a significant number of plant closures, corporate bankruptcies, and employee layoffs. Unemployment rates in Canada have dropped from their postwar peak of close to 13 per cent in late 1982, but the levels remain consistently above those of the United States and Japan. A fairly strong US recovery and a federal budget deficit that is large in relation to GNP on a peacetime basis have not brought the Canadian unemployment rate (seasonally adjusted) below 11 per cent for very long in the two and a half years of the expansion since December 1982.

If this analysis is broadly correct, a significant reduction in unemployment can be achieved over the long term only by dealing with the longer-term structural problems of productivity, costs, and high real wages in Canadian manufacturing. Any improvements here would also permit Canadian producers to take advantage of increases in market access that emerged from further reductions in trade barriers.

International investment flows

In light of the widespread availability of information on Canada's problems of cost competitiveness, one would expect to find some changes in international equity investment, both in the form of less direct investment coming into Canada and in an increased rate of direct investment outside Canada by Canadian-based companies. Both these developments can be seen in the available data. In the late 1960s, more than one-fourth of the inward direct investment from the developed market economies came to Canada. The share invested in Canada has decreased since then; by the late 1970s, the annual flow of direct investment into Canada had fallen to about 3 per cent of the developed market economies' total flows. There has also been a significant increase in foreign direct investment by Canadian firms. From 1975 to 1980, for example, the Canadian equity investment in US manufacturing increased by about 25 per cent per year. Canadian equity investment in manufacturing abroad is now approaching half of foreign equity investment in Canada (Safarian 1983; United States 1984; Statistics Canada 1984). It is possible that Investment Canada, the new organization replacing the Foreign Investment Review Agency, will encourage investment in Canada, but direct foreign investment here may continue to be limited as long as so many other things in the Canadian environment continue to be adverse.

Furthermore, these changes can have no effect on the increased interest of Canadian-based manufacturing companies in locating plants and subsidiaries abroad, which may involve a relative shift from exports from plants in Canada to investments elsewhere to service external markets. Interviews of a matched sample of small Canadian-owned plants and subsidiaries producing identical products (Daly and MacCharles, forthcoming) provide recent evidence that a high proportion of Canadian companies are considering making their next round of expansion outside of Canada. In response to questions about their motivation, the senior executives played down the importance of current or future changes in tariffs as a basis of their planning; they expressed more concern about high costs, high wages, high taxes, and labour-management relations in Canada.

Similar conclusions come from a survey, conducted in late 1983 and early 1984, of 300 Ontario manufacturers employing more than twenty employees. About one-sixth of the respondents had a plant in the United States, and an additional one-fourth had recently investigated the possibility of moving to an American location. A high proportion of the responding companies in Ontario expressed concerns about high labour costs (wages and benefits), the costs of meeting legislated labour standards, and municipal and business taxes (McDonald 1984).[5]

Summary of the findings

This section started by pointing out that internationally high costs would lead, in Ontario and in Canada, to interrelated problems with shares of world trade, profits and business investment, unemployment, and flows of foreign direct investment. The evidence from a variety of statistical and other sources is consistent in all essential respects with the interpretation emphasized here.

The economic pressures being generated in Ontario and Canadian manufacturing at the microeconomic level can lead to a variety of responses both in terms of public policy and private sector responses. The next three sections deal with some of them.

THE COSTS OF A PROTECTIONIST RESPONSE

Given the existing levels of such macro variables as wage rates, interest rates, and exchange rates, economic analysis would predict some further adjustments at the micro level. As we shall see in a later section, some of these adjustments are already underway in Canadian manufacturing.

Another possible response to persisting problems of international competition is for management and labour in the industries most directly affected to put pressure on governments at both the federal and provincial levels to limit or prevent those adjustments from taking place. The issues are essentially similar to the policy problems associated with declining industries. One option for reducing the pressure for adjustment is to introduce (or increase) tariff and nontariff barriers to trade. A second option is a policy of subsidies to investment costs, operating costs, research and development, or export-financing costs. A third option is for the government to buy the ailing firm and operate it as a public enterprise. All three of these options have been used in Canada at various times in recent history.

The fundamental problem with an emphasis on tariff and nontariff barriers to slow or prevent adjustments in Canadian manufacturing is that this policy has been used extensively since the latter part of the nineteenth century; high costs in manufacturing have been its important, continuing legacy, which, in turn, has limited all but selected manufactured exports. I have already reported estimates of the costs of tariffs and nontariff barriers. A given level of nominal and effective tariff rates costs a small country more, as a proportion of real national income, than one that is larger (in terms of population and real incomes). The essential reason is that a large country has a market big enough for individual firms to take advantage of economies of scale domestically. Firms in a small, high-cost market cannot do this even though they know such economies of scale exist. In such a market, given relative freedom of entry, short-term profit maximization behind a tariff leads to high product diversity and small plant size relative to what would occur in a large market. The resulting high costs are more a reflection of a policy failure than of market failure.

Take, for example, Canada's quotas on the imports of clothing, boots and shoes, which affect goods from some of the newly industrialized countries in Asia and the Pacific Rim and which are designed to limit job losses in these labour-intensive industries. Yet these quotas increase clothing costs to the consumers, and part of the gain accrues to the entrepreneurs who have been importing since the base period, rather than to the Canadian workers. The cost per worker-year of maintaining employment is estimated to exceed $35,000. The Canadian textile policy was introduced in 1970 so it has now been in operation for about fifteen years. The discounted present value of $35,000 for fifteen years is a very significant amount for each job maintained (see Jenkins and Evans 1981; Jenkins 1985).

The costs of export constraints on Japanese automobiles coming into the United States have been estimated by Ronald Crandall (1985) at $160,000 per job per year. These are the costs to the consumer. Glenn Jenkins (1985) thinks that the results for Canada are likely to be of a similar order of magnitude.

The costs of these nontariff barriers are large in relation to the numbers of jobs affected. The gains to the individuals and the companies who benefit from these protectionist and selective policies can be very large in relation to their current or lifetime incomes. On the other hand, the additional costs to the consumer are widespread so that the per capita costs are fairly small. There is very little incentive for an individual to write letters to cabinet ministers or members of Parliament or otherwise lobby against the quotas. Very few economists or consumers have taken the time to campaign actively against such quotas, while the companies and labour unions that benefit directly find it very much in their interests to lobby publicly and privately.

The retention of such quotas and nontariff barriers usually operates (and is intended to operate) to preserve the status quo. In some cases, this prevents companies and plants from successfully competing in some specialized niche that has been overlooked by the larger companies in the larger countries. It would be difficult to identify such niches in the world market ahead of time, and it would certainly be impossible to identify them given the existing lack of information at the federal and provincial government level. This problem is particularly difficult as such specialized niches are more likely to be identified by and responded to by relatively small and entrepreneurial firms, and quick adjustments to changing new technologies and world markets are essential for employment growth and corporate profitability.

AN INDUSTRIAL-STRATEGY RESPONSE

In our situation, some people recommend a policy of industrial strategy. The term needs definition in context, but unfortunately, proponents have no clearly stated set of goals and associated policies that one can turn to for a convenient statement. However, there are enough elements of commonality to put forward a few generalizations as a basis of discussion.

A common theme for many advocates of an industrial-strategy response is that instituting appropriate macro policies and leaving decision making at the micro level to the price system and the market economy is inadequate. These analysts tend to have a negative view of the operation of the price system and private-sector decision-making in the domestic economy and an even more negative view of the multinational corporation and associated foreign subsidiaries blaming the parent companies for Canadian manufacturing's limited exports and low productivity. In international trade, they are critical of the operation of comparative advantage based on private-sector decision-making; instead, they would put priority on engineering a comparative advantage based on a structure of Canadian industry more in line with the world environment that they see in the future.

Proponents of an industrial-strategy response tend to emphasize a number of policy tools for achieving such a redirection of human and capital resources in the Canadian economy. In general, these measures would enhance the role and size of employment in manufacturing. Most supporters of an industrial strategy tend to favour manufacturing, and most of them favour the retention (or even increase) of tariff and nontariff barriers to trade. Some advocate them as retaliation against the use of nontariff barriers or contingent protection by other countries. In other cases, the authors propose policy instruments as a way of achieving improved competitiveness; the implication is that barriers to trade would be reduced only after competitiveness is improved. Some authors recommend the more active use of government-procurement policies to place contracts or purchases with Canadian companies to an even greater extent than existing preferences for local suppliers provide.

Another common theme is more active encouragement of domestic research and development in the natural sciences and engineering, and thus the encouragement of high-technology and knowledge-intensive firms and industries within Canada (Britton 1978).[6] Another proposal is the encouragement of world-scale Canadian corporations, but Myron Gordon (1974; 1978) does not appear to have much vocal support for his recommendations along this line.

If this is a fair summary of the goals and instruments of those who advocate a more active industrial policy, what does it amount to? Essentially, a more active policy of protectionism and economic nationalism than we have experienced in the recent past and more interventionism at the micro level than we have known historically in Canada.

My own priorities are for more emphasis on increases in real incomes to Canadians and steps that would facilitate obtaining a larger share of the world market and retaining a share of the domestic market through improved competitiveness. I have three basic concerns about the implementation of the policies supported by the proponents of an industrial-strategy response to our difficulties. First of all, I regard it easier to implement broad macro policies, using fiscal and monetary tools, than micro policies aimed at individual firms and industries. And we are clearly not implementing macro policies very well. For example, Canada has had less success in combatting inflation than the United States since the late 1960s and less than Japan has had since the mid-1970s. In 1981 and 1982, we had a more severe business cycle than the United States, and that was the *first* time in the present century that that occurred. Furthermore, since the fourth quarter of 1982 our increases in real GNP and investment have been more hesitant than the United States', and we have had an appreciably higher level of unemployment. Since about 1973, Canada's longer-term growth in real GNP per person employed and in real output per hour in manufacturing has been more sluggish than those of almost all the other OECD countries. (I am aware that the recovery from the 1982 low has been strong, but it is less than from previous cyclical lows in which the recessions where milder.) When our governments and civil servants and the Bank of Canada have had such a poor record in using broader and simpler instruments of policy, I see no justification in giving them more powers.

A second practical problem is that the rational implementation of the advocated policies would require information at the level of the individual firm and sometimes at a commodity level that the government does not now have. As we saw in a previous section, the available data indicate that the costs of the total manufacturing sector in Canada are high compared to those of other industrialized countries. Yet we are all aware that some manufacturing firms are active and successful exporters. In fact, some of the most promising developments in exporting are occurring in small, Canadian-owned companies. At present, however, the government does not have any hard, current, and comprehensive data on costs and productivity levels at the micro level. Furthermore, it lacks information on what would happen to costs under alternative situations, such as a tripling in output. Developing such information is extremely costly and time-consuming, even for a sample of firms, and companies are unlikely to make it available even to a nongovernment organization, except on a confidential basis.

A further problem is that the political pressures on government in Canada (and probably in most democracies) are likely to be for support of companies, industries, and regions that are unprofitable, unproductive, or perhaps producing the wrong product at the wrong time in the wrong place. Thus, governments end up propping up the losers rather than helping the winners. Every reader could list examples of such support of weakness from the previous Liberal administration.

Notice, however, that the new government has increased subsidies to Via Rail, provided funds for Domtar in Quebec, and is talking of continuing the 'voluntary' quotas on imports of Japanese cars. In other words, the large Conservative majority has not yet resolved the uncertainties about trade and industrial policies in Canada. Until we see evidence of new policies to the contrary, we are justified in assuming that an active program of industrial policy is more likely to slow or prevent change in declining industries than initiate successful change or quick phase-outs.

PRIVATE-SECTOR RESPONSES

The earlier discussion of high costs and high real wages in Canadian manufacturing indicated that domestic firms must make significant adjustments to take full advantage of any policy measures to improve access to export markets. Some of these adjustments have already begun.

Specialization

Discussions of Canada's high-cost, low-productivity performance in manufacturing point out the importance of product diversity and the existence of less-than-optimum plant scale. These studies emphasize the importance of economies of scale and explain that tariff barriers and market size are environmental factors that can and do prevent individual firms from producing at minimum cost levels for given combinations of factor inputs. The economic theory used in these studies predicts that if Canada and other countries reduced tariff and nontariff barriers, three things would happen:

1 There would be an increase in the length of production runs and a reduction in the number of product varieties produced in the typical plant.

2 There would be some increase in plant size (although there is still little comprehensive quantitative data on the effects of plant size on costs per unit).

3 There would be an increase in the two-way flow of trade in manufactured products. This development would be a reflection in international trade flows of the first result – increased specialization in Canadian plants. The product diversity available to consumers and

industrial users would be maintained by the increased range and volume of imports.

These predictions are quite different from those made with models that assume no change in production methods with changes in tariffs. These models show tariffs as having low costs for the economy as a whole, and, therefore, show their reduction or elimination as having little effect on productivity. On the contrary, these models imply a persistence of high costs, significant problems of adjustment for firms and workers (as lower-cost imports lead to corporate bankruptcies and unemployment), and limited hope for increased exports of manufactured products.

Material from special tabulations of the census of manufacturing establishment data at both the commodity and industry level has provided a rich new source of information at a far greater level of detail than anything previously available in the public domain. Published studies based on this new material (Baldwin and Gorecki 1983; Baldwin et al. 1983) indicate a significant increase in the average length of production run while product diversity at the average plant declined between 1974 and 1979. In the same period, there was also an increase in average plant size, and some evidence suggests that larger plants tended to produce a wider range of products than smaller plants. There have also been a number of studies (Grubel and Lloyd 1975; Lermer 1973; MacCharles 1984) showing an increase in the two-way flow of trade in manufactured products. Between 1965 and 1979, there was an increase in both the export orientation and the import penetration for nineteen out of the twenty industries studied. The rates of increase were more rapid for both exports and imports of manufactured products than for the value of manufacturing output or GNP (MacCharles 1984).

There is also more information on differences in the performance and the responses of Canadian-owned companies and foreign subsidiaries within manufacturing. In the early 1970s, Canadian-owned plants were more diversified than US subsidiaries of the same size and industry group. They also had lower levels of output per worker, lower rates of return, and lower liquidity. By 1979, however, the greater degree of product diversity in Canadian-owned plants had become less pronounced than in 1974, and the move to increased specialization was occurring quickly. The ratios of purchased materials to value added, the extent of product specialization, and the ratio of exports to production all increased more dramatically in the Canadian-owned plants than in the subsidiaries (MacCharles 1984).

The comprehensive evidence on length of production runs and the data on international trade suggests more rapid adjustments have taken place in small, Canadian-owned plants and firms than in US subsidiaries. This is also the finding of a study of a more intensive sample of thirty small companies matched in pairs of one Canadian-owned firm and one subsidiary, with each pair producing identical products. At the time of the interviews in 1982, more of the Canadian-owned companies had moved to increased specialization and increased exports than had the subsidiaries. This difference may partly reflect the lower profitability and lower liquidity of those companies at the time, but it was also easier to incorporate changes in corporate strategy in small firms than in the subsidiaries. (Although the longer-term gains from specialization and associated increases in exports appear to be large, evaluation and implementation of a change in corporate strategy can involve a large commitment of time from senior management during that transition.) The amount of foreign direct investment and total investment in manufacturing have both dropped in recent years from earlier highs, but there is little evidence of widespread withdrawal of subsidiaries from production in Canada (Daly and MacCharles, forthcoming).

Although significant changes took place in manufacturing in the 1970s, it is unlikely that all companies will be able or willing to make successful adjustments to lower tariffs and the more competitive environment of the 1980s. New technologies, new products, dramatic changes in exchange rates, and other developments can all require and encourage changes, but there can be resistance to change from management, workers, or both that slows down or prevents the needed adjustments.

Studies by the Economic Council of Canada (Baldwin et al. 1983; ECC 1983, 115-18) emphasize the extent of births and deaths of new firms in the average Canadian manufacturing industry. In 141 four-digit industries, only about 50 per cent of the firms were present in both 1970 and 1979. By 1979, more than one-third of the firms in existence had not been in operation at the start of the decade and more than 40 per cent of the firms present in 1970 had exited. Relatively more of the plant scrappings had occurred in declining industries, of course. It is significant, however, that total employment in manufacturing had increased by 13.7 per cent or 1.3 per cent per year compounded over that decade in spite of the death of more than 40 per cent of the firms in existence in 1970. In commenting on these results, the ECC states:

> Bearing in mind that these averages cover 141 industries, the picture is one of an extremely dynamic industrial structure, with literally thousands of entries and exits over the decade. The turnover is enormous. (1983, 115)

In light of the severity of the 1981-2 recession, the sluggish recovery since, and the low rates of returns in Canadian manufacturing, it is likely that the annual rate of exits of companies has been even higher since 1979.

Workers and change

A tremendous number of job changes also take place each year. In the 1970s, the total number of job changes *each year* was almost as large as the number of people in the labour force. Part of this turnover was associated with young persons, part-time workers, and people in seasonal industries, but it is also clear that firms can achieve important reductions in staff by attrition and reduced new hirings.

A special study was made of workers who were laid off permanently in some declining industries during the 1970s (ECC 1983, 119-23). The industries covered included clothing, primary textiles, and electrical products. About two-thirds of those laid off subsequently found another job; almost another fifth left the labour force. Most of those who find another job after being laid off do so quite quickly, but a small percentage of apparently hard-core unemployed were still without work two years after being laid off. It is also worth noting that it was probably easier to find alternative employment during the period covered by the labour-tracking survey than it has been since 1981. The adjustment would also be more difficult if the employment declines occurred in such high-income industries as steel and cars while the employment growth was in such low-income industries as retail trade and services.

In some cases, workers who have been laid off in declining industries end up with income losses either during an interim period of unemployment or in new jobs at lower rates of pay than their former jobs. Estimates of the present value of income lost by displaced workers in declining industries have been made for selected cities in Ontario and Quebec with breakdowns by age, sex, and marital status (Jenkins 1980; 1985; Glenday, Jenkins, and Evans 1980). For about half the male categories, the income loss was less than $1,000. It was more for females, ranging from $3,000 to $6,000. Expressed in terms of present value, these income losses were quite modest and certainly well below the costs per 'job saved' per year of nontariff barriers on clothing and Japanese auto imports.

For people who live in a particular region or work in a particular company and occupation, the possibility of change from layoffs can be threatening. Workers have invested in certain skills, built up pensions in one firm that may not be portable to another, and invested in homes. A move may involve income and/or capital losses. There are also very large differences in attitudes towards change. If the previous generation or so of a family experienced major change (in terms of city, country, and occupation) and it was successful, the family may be quite open to further change. On the other hand, if a family has lived on the same farm or in the same community for generations, it may feel much more threatened by the need to change. These attitudinal differences can be very important in the willingness to consider and the ease of implementing change.

Changes for the future

Although the previous pages have indicated that a significant amount of change has taken place in Canada since early in the 1970s, the section on microeconomic problems in manufacturing indicated that significant further adjustments are necessary to get Canadian costs closer to the levels of our closest competitors. These changes are essential if Canada is to take full advantage of any further improvement in access to world markets made possible by future reductions in tariff and nontariff barriers.

Two steps are required. First, further increases in productivity in relation to both labour and capital inputs are essential. A once-for-all increase would not be sufficient as the other countries are not standing still; in fact, they have continued to increase more rapidly over the last decade than has Canada. Second, a sizeable part of any future productivity increases should be passed along to the buyers of manufactured products both internationally and within Canada. This has been an important part of the Japanese success in increasing world market share and maintaining low unemployment while also achieving larger increases in real wages.

Summary

It is useful to summarize the main conclusions from the evidence and analysis in this section. Very significant adjustments have been taking place in Canadian manufacturing over the last decade, partly in response to international market influences and the associated threats and opportunities to the traditional high-cost but historically protected sector. There has clearly been an increase in specialization in the average plant, with increases in the length of production runs and in plant size. There has also been a high rate of both births and deaths of individual firms over the decade. A significant development was the success (as measured by exports, growth, and profitability) of a significant proportion of smaller, Canadian-owned firms. The successful companies developed a 'niche strategy' of identifying a gap in the market that had been overlooked by the large companies in the large countries; entrepreneurial managers matched the interests and expertise of their organizations to the market gaps. Many subsidiaries had already become more specialized by the early 1970s, and further recent changes have been less pronounced. Some of these companies are involved in exporting, but the international trade of these firms is based more frequently on plant specialization in different countries (with significant transactions between affiliated companies) than on the world product mandates that have received so much publicity in Canada.

It is also clear from the evidence summarized in the section on microeconomic problems that significant further adjustments in Canadian manufacturing are likely in response to the heavy international competition of the early 1980s. The differences in cost levels between Canadian and foreign producers and the disequilibrium between real wages and real output per hour are too great to persist without continuing long-term pressures on profits, living standards, and high unemployment rates. Furthermore, manufacturers in other countries are continuing productivity increases and adopting new technology faster than Canadian manufacturers.

Public policy at both the macro and micro level needs to be based on a much improved understanding of longer-term changes in productivity, real wages, and unit labour costs at the micro level for Canada in an international perspective. The extent of the gains from and the ease or difficulty of any adjustments can be understood only through more information on and discussion of these micro developments. A key policy issue is whether these dynamic changes should be permitted (or even encouraged) or whether policies should be used to slow or prevent them.

CONCLUSIONS

A number of conclusions emerge from this paper. Economic theory and public policy must incorporate information on the broad economic performance on the cost and supply sides at the micro level to permit an informed macro view of the nature of performance problems for increasingly open economies of the size of Canada. Such analysis must involve some integrating of information on Canadian industrial structure and international trade with comparisons with its closest international competitors. This important area has not had the research or public discussion it deserves.

A second important conclusion is that improved market access (whether on a bilateral or multilateral basis) is a necessary but not a sufficient condition for increases in exports of manufactured products to lead to increases in productivity and real incomes for Canadians. Further increases in productivity are essential, and an important part of such increases must be passed to the buyers of manufactured products if increased market share and employment are to be attained on any long-term basis. The federal government discussion paper on trade policy (Kelleher 1984) did not really raise or discuss these issues,[7] and it was also not discussed seriously in the November Department of Finance paper (Canada 1984). Yet these issues are too important to continue to be ignored in the public discussions and government papers that are part of the consultation process. International competitiveness for Canadian manufacturing is closely related to trade policy and market access and is key for many of the issues covered in the papers and the discussions at this conference.

Further adjustments in manufacturing are still necessary. Given significant international changes in exchange rates, differing inflation rates, new technological developments, and so on, it is not clear where future jobs will come from. Past Canadian experience could well be a misleading guide for the future, as the past still reflects the legacy of higher tariff rates. Significant changes in export orientation, import penetration, and intraindustry trade have taken place, but we do not have the expertise to predict the associated future changes in input-output co-efficients. What is clear is that the status quo (including wages, exchange rates, and productivity levels relative to other countries') is no longer able to provide to the corporate manufacturing sector increased real wages, low unemployment, and adequate rates of return on further investment in modernized, more efficient facilities that use new technology more adequately.

The sections of this paper on the costs of protectionism and industrial strategy suggest that at the micro level these responses would likely perpetuate the problems of low productivity, low profits, high costs, and high unemployment. Such developments would continue to be associated with losses in market share, both internationally and domestically.

A key issue is whether public policies will encourage the flexibility and adaptability that increased international interdependence requires. During the depths of the recession, some plants and firms in manufacturing continued to thrive by specialization and increased exports, while others were closing. The most rapid growth in employment has been in smaller plants and firms, but economists, banks, and governments do have the information to predict ahead of time which ones will succeed and which ones will not. To say that all existing plants (and their management and workers) should be supported is an inappropriate response.

Some form of adjustment assistance to workers and adequate training and retraining will be necessary, as Harris points out in his paper in this volume. These policies have been fairly fully discussed over the years.[8]

Increasingly open economies like Canada's have the most to gain from an open, dynamic, and competitive world economy. However, further reductions in tariff and nontariff barriers are only part of the story, especially when tariffs have already been reduced significantly. It is essential that Canadian costs be reduced to world levels in a large number of products, rather than only in the selective few that have thus far emerged in Canadian manufacturing.

This analysis would not be universally accepted. Pilkey's paper in this volume and the statements by union leaders at the National

Economic Conference favour increased stimulus on the demand side and, by implication, deny the existence of any widespread productivity and cost problems in manufacturing. Full consensus on these issues has clearly not yet been achieved.

NOTES

1 Harris and Cox (1983) use a general-equilibrium simulation approach that explicitly allows for economies of scale at the industry level.

2 Daly (1979a), Daly and Globerman (1976), and Daly and MacCharles (forthcoming) summarize this evidence and include many references to related studies.

3 These issues have become part of the policy debate in the United Kingdom and Europe. See *The Economist* (1984) and Albert and Ball (1983).

4 Comparable charts have been included by Barbara Smith in *The Globe and Mail*.

5 This study was brought to my attention by Jim Bennett at the Ontario Economic Council conference.

6 For a critique and alternative interpretations and policies, see Daly (1979); Palda (1979); Wilkinson (1980, 1982).

7 The brief prepared for the February 1985 First Ministers' Conference in Regina (Canada 1985a, 9, 13) referred to the data on output per hour in Canada, the United States, and Japan. It is possible that the lack of tie-in between trade policy on the one hand and macro and industrial policies on the other reflects the traditional departmental jurisdictions. See 'Stevens vs. Clark: Can external hang on to trade policy?' *Globe and Mail*, 11 May 1985, p. 4, for example.

8 See, for example, Matthews (1971); OECD (1984); Jenkins (1985); and Helliwell (1985).

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Jobs and free trade

Richard G. Harris

My purpose in this paper is to ask the basic question of whether jobs and free trade are in some sense compatible with one another. 'Jobs' is a simple word to describe a rather complex set of relations between workers and firms in the labour market; the dimensions include the quality of the work in a particular job, its expected permanence, and, of course, the wage that is paid. 'Free trade' is an equally simple term that is much abused and about whose exact meaning there is little agreement. In this paper I use 'free trade' or 'bilateral free trade' (BFT) to refer to complete, bilateral removal of tariff and significant nontariff barriers to trade between Canada and the United States. ('Nontariff barriers' here include such things as US countervail duties and Canadian export subsidies. It is not meant to be interpreted so widely as to include policies, such as the extent of government ownership in a particular firm or the structure of indirect taxation.) This country-specific definition of 'free trade' is, of course, hardly general, but it allows a certain economy of expression in what follows.

That the paper focuses on Canada/US bilateral free trade, rather than other forms of trade-liberalizing agreements, is obviously because that is what is currently on the agenda for Canadian trade policy. It is also, in my view, the only realistic alternative that exists for Canadian trade policy at the moment. The high unemployment and severe adjustment problems faced by most of the European economies mean that another round of multilateral trade talks under

Professor Harris is a member of the Department of Economics, Queen's University, Kingston, Ontario.

the General Agreement on Tariffs and Trade would most likely be quite unsuccessful, particularly on the difficult issues of nontariff barriers. It is not my intention to review the case for a bilateral versus a multilateral approach to Canadian trade policy at this time.

The issue of jobs

The discussion of Canada/US free trade has traditionally centred upon such topics as the potential of such an arrangement for increasing trade between the two countries, the gains in productivity that could be achieved through the rationalization of Canadian industry, and the resulting real-income gains to Canadians. More recently, the discussion has extended to the problems of North American industry arising from the intense foreign competition from low-wage countries, such as South Korea and Hong Kong, as well as the traditional competition from Japan.[1] At the same time, the increasing importance of the service sector in all industrial economies has raised serious questions regarding the potential future importance of trade in services as a substitute for trade in goods.

Although a great deal has been written about all these aspects of Canada/US free trade, rather little has been said, at least by professional economists, about its consequences for jobs. In particular, would a comprehensive Canada/US free-trade arrangement result in the net creation of jobs in Canada? If so, what type of jobs and for whom? These are central questions, and judging be recent press reports, the public certainly thinks it knows some answers. Two of the most popular perceptions are that:

1 Canadian jobs would be lost to the United States as large US firms won over noncompetitive and relatively weaker Canadian firms in the fight for market share.

2 Additional jobs would be lost as Canadian subsidiaries of US firms shut down since they would have no particular reason to produce from a Canadian location.

The regional significance of these arguments is, of course, great. In terms of jobs lost, Ontario is perceived as the biggest potential loser from free trade. It is my intention in this paper to point out that the issue of jobs and free trade is far more complex than these two simple arguments suggest and that they are both incorrect, at least as far as economic logic and existing evidence are concerned.

DIMENSIONS TO THE JOBS ISSUE

In this paper, I focus on six basic questions that cover the most significant of labour's basic interests with respect to a free-trade arrangement with the United States:

1 Would BFT create long-term jobs in Canada?

2 Would BFT lower wages for Canadian workers in the long term?

3 Could protection of the Canadian market through tariff and other nontariff measures sustain long-term employment in the face of other external shocks?

4 Would the quality of jobs under BFT be better than under protection? (In addressing this question, I equate 'quality' with the long-term employment of a given worker with a particular firm.)

5 How large would the short-term job losses be upon initiation of BFT, with or without a phasing-in of the arrangement?

6 What type of government programs would best assist workers who lose jobs directly because of BFT?

Underlying all of these questions are some difficult issues involving the nature of economic justice and equity. It has become popular for government to guarantee to specific workers specific jobs. This is true not only of trade policy but of almost all conceivable government policies. Yet government cannot guarantee specific jobs for specific workers in any realistic sense; to claim otherwise is simply to distort reality. Government can put in place policies that preserve the viability of specific jobs for a short time, but only by jeopardizing jobs that exist elsewhere in the economy. Moreover, the nature of economic policies is such that the jobs that are preserved are usually clearly identified but the jobs that are lost through the same policy are never identified as such.

Take a common example. If a particular Canadian firm is noncompetitive with foreign competitors, jobs in that firm can be maintained by erecting a tariff barrier on the goods it produces. The consequent rise in these goods' prices to Canadian consumers, be they other firms or final consumers, will ultimately lead to the reduction of jobs elsewhere in the economy. The most obvious case is that of a Canadian firm that uses the good as an intermediate input to production; the rise in the price makes that firm less profitable, causes a reduction in investment, and thus results in the loss of jobs within that firm. Often the number of jobs lost is small, but many firms are users of the good. Thus, it is quite possible that the total number of jobs lost will exceed the number saved by the tariff. It is a great misfortune that in the heat of political debate, this simple economic fact is often forgotten.

The issue of specific jobs versus jobs in general is something that comes up repeatedly in the political and economic analysis of protection. The bottom line is that economic analysis cannot identify *ex ante* the specific jobs that will be created in response to a change in economic policy. Jobs that may be lost are more easily identified *ex ante* by both economists and policy makers; hence the inherent difficulty of selling 'two birds in the bush' for 'one in the hand' policies.

FREE TRADE AND LONG-TERM UNEMPLOYMENT

Clearly, adoption of BFT would have consequences for long-term unemployment. The 'long term' is defined here as a length of time sufficient for resultant wage changes (plus any reallocation of investment) to work themselves out so the structure of industry and labour markets becomes restabilized in the absence of other external or internal shocks. Essentially the economy would have adjusted to the free-trade arrangement, whatever form that adjustment might take.

All industrial economies are currently facing severe structural-adjustment problems emanating from labour-market demographics, low-wage foreign competition, and technological change. The first subissue then within the broader question is whether structural unemployment would be higher with or without BFT. Here I do not find any particular reason to be pessimistic, and there are some good reasons to be optimistic. Long-term structural unemployment in Canadian industry occurs because of mismatches between labour supply and demand by region and occupation.[2] The regional problem is obviously of great importance, given the geographic size of the country. BFT, by guaranteeing Canadian resources access to the US market would imply that, on average, employment in the resource regions could be maintained when it would otherwise be threatened by US protectionist action, such as that currently being taken against British Columbia's softwood exports.

Within the manufacturing sector, the benefits of a BFT for structural unemployment would be of considerable significance. In this sector, technological change and foreign competition are the major sources of long-term job losses. The great hope for North American industry over the long term is specialization in products that have a high value-added and that require a high skill and technology base. The firms and industries involved must, however, be competitive at the world level. For Canadian firms and workers, the overwhelming importance of being globally competitive necessitates, at minimum, guaranteed access to the US market. The degree of scale economies and specialization required is not consistent with serving the Canadian market alone, as numerous studies have documented.[3] A BFT would not ensure the long-term viability of jobs within the Canadian manufacturing sector, but the absence of such an arrangement would certainly guarantee that in the face of protectionism in the rest of the world, Canadian manufacturing workers would become low-wage, low-skill, and often unemployed.

The second form of long-term unemployment that economists are used to dealing with is what is termed frictional unemployment, the movement of workers in and out of jobs that is required for the normal functioning of the labour market. The so-called long-term natural rate of unemployment is a measure of how much of the labour force must be unemployed so that labour demand and labour supply match on average without causing inflationary wage changes.[4] For Canada, estimates of the natural rate of unemployment in the 1960s and 1970s ranged from 4 to 8 per cent.

In an open economy such as Canada's, a crucial determinant of the natural rate is exposure of the economy to external shocks. An economy exposed to greater variability in external shocks is likely to have a higher natural rate of unemployment. Some would argue that BFT, by increasing the openness of the Canadian economy, would increase its exposure to external shocks and thus raise the natural rate of unemployment. I think there are two problems with this argument. First, Canada already exports a large fraction of its GNP – on the order of 25 to 30 per cent. It is unlikely that BFT would raise the aggregate figure substantially. Second and more important, the largest potential external shock that Canadian exports face, other than those imposed by the business cycle itself, is the possibility of protectionist action by other countries. BFT would ensure that about 80 per cent of Canadian exports would be free from such shocks, thus reducing a significant uncertainty in the economy. Furthermore, BFT would divert trade towards the United States. (Cox and Harris [forthcoming] calculate that about 10 per cent of Canadian trade would shift from other countries to the United States under BFT.) Thus, the insurance effect of eliminating US countervail on Canadian exports would be even stronger than it appears when one uses existing trade patterns as the basis for calculation.

Another argument with respect to the level of frictional unemployment is that under BFT the quality of jobs is likely to rise. (The reasons for this prediction are given below.) High-skilled jobs in industries that have guaranteed access to the US market are much more likely to provide long-term contracting between workers and firms than are low-skill jobs in highly vulnerable industries. The existence of more permanent arrangements between workers and firms would make layoff a less likely response to short-term fluctuations in demand. BFT, by helping the economy shift to a higher proportion of permanent jobs, would thus be likely to lower the long-term rate of natural unemployment.

REAL WAGES AND BFT

That Canadian workers' real wages would rise over the long term under BFT is an unassailable argument. It is made in numerous studies, beginning with one by Paul and Ron Wonnacott (1967) and more recently in one for the Ontario Economic Council (Cox and Harris, forthcoming). The argument is simple with respect to wages in the resource sectors and services. Protection has raised the cost of goods used by consumers and firms in these sectors and thus reduced the real wages attainable by labour. It is fairly simple to estimate the impact on real wages of reducing protection in these sectors; achieving a 5 per cent reduction in the cost of a bundle of consumption goods by lowering protection on Canadian imports would raise real wages by 5 per cent (holding nominal wages constant).

Of more importance, however, is the adverse effect that protection of Canadian and of US industry has had on productivity in Canada. Numerous studies document the severe effect that a small domestic market plus restricted access to foreign markets has had on productivity in Canadian manufacturing (see Don Daly's survey in this volume). BFT would bring substantial productivity gains to Canadian industry and ensure the maintenance of those that have already occurred through rationalization, greater specialization, and the achievement of scale economies.

The interesting thing to note is that in the long term these productivity gains would accrue almost entirely to Canadian workers in the form of higher real wages. Thus, labour would be the principal long-term beneficiary of BFT. The reason is simply that the return to capital is determined in the long run by forces exogenous to Canada. Various firms would experience gains and losses under BFT, but over the longer term, forces in the world capital market would equalize long-term rates of return on investment between Canada and the United States; labour would be the factor of production experiencing the principal gains. Wonnacott and Wonnacott (1967) put these potential gains at about 10 per cent of GNP, and subsequent studies confirm this type of estimate. Cox and Harris (forthcoming), for example, estimate that in the process of raising productivity of Canadian industry, substantial investment would accompany industry rationalization. On balance, the number of jobs created within manufacturing would exceed the number lost.

CAN PROTECTION SUSTAIN LONG-TERM EMPLOYMENT?

Given the structural change facing the Canadian economy, it can be argued that jobs could be preserved in the long term through import substitution (so long as one is willing to accept the substantial efficiency losses resulting from such a policy). If this argument is correct, it provides a case against BFT, given the importance of jobs in policy makers' objectives.[5]

I think the argument is quite dubious. With or without protection, the number of jobs is determined in the long run by basic conditions in the labour market. An economy with flexible labour markets and a high capacity to adjust will have full employment with or without protection. Let us assume then that the Canadian labour market is inflexible and that considerable rigidities built into our system of labour relations prevent wages and employment from adjusting over the long term. In such circumstances, the long-term effects of protection are (1) to reduce aggregate real income, and (2) to develop or preserve a highly inefficient import-competing sector. I suggest that the consequence of both these effects is to reduce the capacity of the economy to adjust to external and internal shocks.

The most important external shock that reoccurs regularly is the world business cycle. During downswings, an inefficient manufacturing sector is hard pressed to compete with price-cutting by importers, even in the presence of protection. If wage rigidities are present, the cycle causes more layoffs than would occur without the wage rigidities. An efficient manufacturing sector that is oriented to exports and world markets is subject to the same cyclical influences but not to the same kind of price-cutting pressures that the import-competing sector faces. As protection induces lower aggregate real income and hence wealth, the economy's capacity to run a countercyclical fiscal policy is correspondingly reduced. Another way of putting this argument is that protection may save jobs in the short run by reducing economic growth over the longer run. Countries with a relatively high rate of economic growth are in a much better position to deal with cyclical adjustments than those with low rates of economic growth. Thus, the long-term job-creation effects of protection are, in my view, most likely to be negative, producing a dependent, low-growth economy vulnerable to external shocks.

At a slightly deeper level of analysis is the question of the possible effect of BFT on labour-market rigidities in Canada. This question has received little attention but is of considerable interest. BFT could well force labour markets within Canada to become more like those of the United States. I know of no studies supporting this view, but if it is true, BFT might help us achieve something close to the United States' relatively low rate of unemployment.

THE QUALITY OF JOBS

In discussions of jobs and unemployment, a recurring theme is that the unemployed are not interested in jobs per se, but in meaningful jobs with good wages, security, and the prospects for advancement plus utilization of any skills they have acquired. Clearly, many people prefer unemployment to a menial job. Using wages as the sole measure of job quality oversimplifies what is obviously a complex package of job characteristics, some of which can be traded off against others. For the purposes of this paper, I focus on two dimensions of job quality – degree of permanence and wages. I define a low-quality job as one in which there is no tenure, a high turnover rate, and generally lower wages. However, workers will accept lower wages for guarantees of tenure with the firm and hence reduced possibility of unemployment.

As a society, we obviously place considerable value on the economy's capacity to generate permanent jobs. Would BFT increase or reduce the proportion of the economy's jobs that are permanent? This is an issue about which there is little direct evidence, but certain implicit assumptions are often invoked in discussions of free trade. The view of Canada as a resource-based economy with little comparative advantage in high-skill industries suggests that under BFT, specialization in the resource sectors might increase the proportion of the labour force employed in low-skill, cyclical work and thus raise the proportion of temporary, as opposed to permanent, jobs. However correct this view may have been in the past, it hardly applies to the current situation. The resource sector is highly capital-intensive and employs only a small fraction of workers – less than 2 per cent of the nonagricultural labour force in 1983. To the extent that BFT would stabilize resource exports, it would increase the number of permanent jobs within that sector. This stabilization would also have important, positive spillover effects in the nontraded-goods sectors within the resource-based regions of the economy.

Within manufacturing and service industries, the issue of job quality is considerably more complex, particularly in light of the current adjustment problems facing these sectors. In general, BFT would provide an environment in which the development of world-class, high-skill industries could occur. As we have seen, it is these industries that offer the greatest potential for high-wage, high-quality jobs in the future.

The service sectors continue to provide a major source of employment in the economy, and there is little reason to expect this trend to reverse itself. The traditional line between goods-producing industries and service industries is quickly becoming blurred with the continued growth of the information economy. Trade in services is clearly going to become an important feature of Canada/US trade in the future. Financial services, transportation, and management services are just a few of the areas in which trade between the closely integrated economies is likely to grow. This form of economic activity is clearly going to provide a lot of the better-quality jobs in the future.

If Canada is to get a share of this activity, it will do so much more readily under BFT than without it.

SHORT-TERM JOBS AND BFT

Apprehension of short-term losses of jobs and labour-adjustment costs are undoubtedly one of the major reasons labour worries about the consequences of liberalizing trade. It particularly fears competition from low-wage countries, but similar fears exist with respect to competition from the United States.

Unfortunately, there are very few estimates of what BFT might entail in short-term job losses, never mind the adjustment costs it might impose on the economy. The most pessimistic view is that the removal of trade barriers between the two economies of unequal size would result in an immediate loss for the smaller of a large number of jobs in the import-competing sector, with no net job creation in the export sector. Yet there is no reason to expect this particular asymmetric pattern of adjustment to occur. A number of studies bear indirectly on this question; it is worth reviewing some of them to get an idea of the basic magnitudes involved.

The first question is the size of the ultimate adjustment. David Cox and I (Cox and Harris, forthcoming) find that complete removal of bilateral trade barriers between Canada and the United States, measured as of the early 1980s, would involve an intersectoral shift of 7 per cent of the labour force. (This is not a full measure of the ultimate adjustment because within each sector rationalization of industry would result in a significant interfirm shift of the labour force.) This estimate of the intersectoral adjustment is relatively large compared to the estimates of some US studies, but it reflects the greater degree of rationalization required in Canada's economy than in the United States'.[6] However, there is evidence that a significant amount of rationalization has already occurred with the tariff reductions of the Tokyo Round.[7]

The short-term results could be quite different from those of the longer term, given the wage rigidities in many industries and the impossibility of the capital stock's adjusting immediately in the face of new competition. If BFT is announced as becoming effective at some future date, the short-run results could be felt well in advance of its actual inception; anticipation would likely have effects on investment, layoffs, and wage negotiations. Unemployment would occur in import-competing industries, and, at the same time, jobs in the export sectors would be created.

Any economic analysis of the short-term employment effects depends heavily upon the assumptions made about wage adjustments in the face of unemployment and about the behaviour of the exchange rate over the short term. Let me treat each of these in turn.

In some exploratory work using the GET model (whose structure is reported in Harris and Cox [1983]), I ask: what would be the short-term employment effects of an immediate and complete reduction in Canada/US bilateral trade barriers, assuming both the structure of nominal wages and the Canadian exchange rate are held fixed? Surprisingly, the answer is an increase in aggregate employment of about 5.5 per cent. Out of twenty-nine industries, eighteen expand in employment and eleven contract. These results depend upon assuming export and import elasticities of moderate values and additionally on assuming that capacity constraints do not bind in the expanding industries within the time horizon envisaged (slightly under three years). If capacity constraints bind, the aggregate employment-creating effect is smaller. This result points out the importance of the export sectors as job creators in Canada. Even though fairly significant amounts of import substitution occur, BFT creates jobs on balance, even within the short run. (Of course, moving labour from one industry to another is not costless, and therefore we must be cautious to not understate the short-run costs of adjustment to BFT.)

My results are not atypical of those produced by economic models built for the purpose of analysing trade policy. Using a similar model of the Australian economy, Dixon, Powell, and Parmenter (1979) ask what would happen to short-term employment with implementation of a 25-per-cent cut in domestic tariffs, holding real wages constant. They find that cutting domestic tariffs would leave aggregate employment virtually unaffected with a rise of about 0.05 per cent. (These results are much less favourable for employment than those of the Canadian case because the latter involves reduced barriers to Canadian exports to the US market.)

What about exchange-rate adjustments in response to BFT? Given a flexible exchange rate, a powerful determinant of employment in the short run is the response of the exchange rate to the initiation of trade liberalization. Here the concern might be that BFT would cause the

Canadian exchange rate to appreciate, making exports more expensive and imports relatively cheaper and thus leading to a decrease in employment or an increase in aggregate unemployment. This question has been addressed by a number of analysts, starting with the famous Canadian economist Robert Mundell (1961): They have used a variety of theoretical models, all emphasizing short-run labour-market rigidities as the basic source of unemployment. All come to the same conclusion: Lowering the trade barriers of a small country, given sluggish nominal or real wages, causes a depreciation of its currency in the short to medium run. This assists in lowering unemployment beyond what would otherwise occur with no change in the nominal exchange rate.

Unfortunately, there is no direct empirical work on this particular aspect of the problem, since there has been no significant trade liberalization by a small industrial country in the period of floating exchange rates. Yet there is no evidence to suggest that Mundell was incorrect in his basic conclusion regarding the short-term response of the exchange rate. (It is worth noting that in the Canada/US case, the Canadian exchange rate would do most of the adjusting in the short run, given the dominance of Canada/US trade as a share of total Canadian trade compared to its share of total US trade. Indeed, one would expect BFT to have little impact on the US dollar vis-à-vis other major currencies.)

The other short-run aspect of BFT and jobs is the extent to which it would mitigate the flow of investment out of Canada into the United States. As widely publicized in recent press reports, a large number of Canadian firms have been investing directly in the United States by building plants there in response to the perceived threat of protectionist action by the United States. BFT would stem this outflow of investment to a considerable degree, not only preserving the jobs that are lost as a direct result of the movement of production facilities out of Canada but also raising aggregate demand by stimulating investment in Canada. The rise in aggregate demand would stimulate employment in Canada.

A final issue is the role of Canadian subsidiaries of US multinationals in choosing plant locations under BFT. What of the argument that jobs will be lost as these subsidiaries move out of Canada? Since this issue is discussed elsewhere in this volume, I will not dwell on it here. Let me say only that there is little evidence to support the pessimistic view. Certainly, some branch plants would likely shut down, but others would not because their sunk costs are particularly large or because their Canadian location would be no disadvantage relative to US location. By specializing in certain product lines, a plant could achieve economies of longer production runs and serve the North American market and possibly the world market. A number of Canadian subsidiaries of US multinationals have received world product mandates; under BFT, there is every reason to expect this type of specialization would increase.[8]

ADJUSTMENT PROGRAMS UNDER BFT

A policy such as BFT is certain to create both losers and gainers. An important part of government policy is designing programs and policies so that the cost is seen to be borne equitably. Canada has in place a number of programs that go beyond the basic support provided by unemployment insurance to ease the burden of adjustment on labour when it faces competition from imports. The question arises as to whether special programs would be needed in the event of the adoption of BFT.

One of the difficulties with a support program based on the adoption of a particular policy such as BFT is deciding how much of the unemployment comes directly from the adoption of the policy and how much from the rather large number of shocks that the economy is exposed to routinely. I do not think there is any adequate way this separation can be done, but at the same time it seems politically imperative that the burden of adjustment, particularly for older workers, be alleviated to some extent. Jenkins et al. (1978), in a study of Quebec plants affected by import competition, find the private income losses from import-induced unemployment to be considerable; for a plant using high-skilled labour, they put them at $1,294 to $4,891 in 1971 dollars. The unemployment of the laid-off workers had a mean duration of 6.7 months but a median duration of only 2.7 months. This difference points up the fact that for a few workers the layoffs from plant closing will induce unemployment that is virtually permanent or at least very long.

I do not think it is necessary to introduce additional programs to deal with labour adjustment to BFT, but existing programs, such as the Industry and Labour Adjustment Program (ILAP) and the Labour Adjustment Benefits Program (LABP), might receive some additional funding over some extended but fixed period after the introduction of BFT.

Moreover, some steps could be taken in negotiating a free-trade arrangement that would alleviate the burden of adjustment on labour. First, the arrangement should be phased in gradually, say over five years. Second, the United States could reduce its barriers first in order to allow smaller Canadian firms to adjust for the larger market. It is quite likely the United States would agree to such an asymmetric arrangement, which is recommended by Wonnacott (1985); there is precedent in the Auto Pact.

In summary, although certain workers would be adversely affected by BFT, these considerations alone are not a reason to avoid going ahead. The economic case suggests the adjustment costs can be stretched out over a considerable period. Furthermore, if BFT could be initiated during a period of expanding economic growth, it is obvious that the burden of adjustment on labour would be considerably less than it would be during a trough in the business cycle.

CONCLUSION

In this paper, the case for a comprehensive free-trade agreement between Canada and the United States has been examined from the point of view of Canadian labour. The conclusion is that in both the short and the long run, labour would benefit substantially from such an arrangement in terms of both the quality and the quantity of jobs available. Real wages would rise significantly, and employment-generating investment would be attracted. A free-trade arrangement would ensure investment and market opportunities for the development within Canada of value-added, high-skill industry capable of competing with Japan and the newly industrialized countries without substantial cuts in wages. Ensured access to the US market is a necessary condition for the development of such industry. Although a Canada/US bilateral free-trade arrangement would mean that some workers would lose jobs in some industries, its basic impact on aggregate employment, even in the short run, would be positive. Adjustment costs could be mitigated by a gradual removal of trade barriers.

In short, from the point of view of Canadian labour, the case for a free-trade arrangement is significant.

NOTES

1 Both aspects of the free-trade debate are surveyed in Harris (1985).

2 For a definition of structural unemployment, see Lipsey, Purvis, and Steiner (1985, chap. 37).

3 See Don Daly's paper in this volume for a survey of this evidence.

4 The definition of the long-term rate of natural unemployment is reviewed in Lipsey, Purvis, and Steiner (1985, chap. 36).

5 In recent years, the most influential group advancing such an argument has been the 'Cambridge economic policy group' of economists from Cambridge University. F. Cripps and W. Godley (1978) is one prominent example of their published analysis and recommendations.

6 US studies give extraordinarily small estimates of labour adjustment costs. Harris, Lewis, and Purvis (1984) provide a survey of these, reporting estimates of adjustment costs that are often less than 2 per cent of the net benefits from reducing tariffs on imports.

7 See Baldwin and Gorecki (1984), for example.

8 Harris (1985, chap. 5) discusses the evidence and theory on world product mandating.

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Discussion

QUESTION: We heard this morning that the Ontario labour movement fears free trade because it would make cheap labour available and because investment would be withdrawn and plants closed here and production moved to the American south. Professor Harris, how would you convince labour leaders that your prediction is more accurate than theirs?

RICHARD HARRIS (Queen's University): In the long run, capital is not a scarce factor for this country because it comes in from abroad. We have only two scarce factors: resources and the labour force.

All the results from my Ontario Economic Council study of last year suggest that free trade is not going to destroy investment. You can read the reasons daily in the press. Quite simply, if Canadian producers – or foreign producers for that matter – had guaranteed access to the US market, they would have no incentive, other things being equal, to move their production facilities. As for the location of new investment in footloose industries, a host of considerations influence decisions. Of major importance is the fact that Ontario and Quebec – indeed, all parts of Canada – can provide a highly skilled labour force that wants to live here. Capital will move where labour wants to live.

As for the severe cost differentials in labour that exist between North America and the newly industrialized countries for some products, I don't see that bilateral free trade between Canada and the United States can solve that problem at all.

If the tariff barriers came down, would the subsidiaries now serving the domestic market in Canada leave? Certainly nothing in economic theory suggests that would occur. And there are data to support the hypothesis that they would not leave in a number of industries.

DON DALY (York University): Perhaps I could add a bit more to that. As I described in my paper, D.C. MacCharles and I have been working with a small, matched sample of Canadian-owned and subsidiary companies. What emerged in the interviews was that the small, Canadian-owned firms are moving much more quickly to specialization. They had started off with a greater degree of product diversity in the 1970s but have moved much further in the direction of specialization in recent years. Another thing that emerged was that, as Rick Harris is suggesting, there is little indication of the subsidiaries' pulling out. We interviewed not just the subsidiaries in Canada but also some of the parent firms in the United States.

We also found no general evidence on either side that the parent firms were preventing the export of manufactured goods to the States. The limiting factor was primarily the high cost of Canadian manufacture, the same problem that was affecting the Canadian-owned firms.

It's worth noting that it can be a long, slow process at the management level for a subsidiary to specialize if doing so involves a major shift from its historic objectives.

A more disturbing thing is a topic that hasn't even come up: the very large amounts of foreign direct investment by Canadian companies. The figure has been going up by about 25 per cent a year compounded over the last five years. *Canadian* companies find Canada unattractive to continue to invest in.

BERNARD WOLF (York University): Could the two members of the panel comment on the impact of recent changes in technology in computer-assisted design and computer-assisted manufacturing. Given the nature of the Canadian economy, will they change the gains to be had from economies of scale?

DON DALY: The potential is very great for the use of computer-assisted design and manufacture and beyond that, for the use of new inventory-control systems and a whole range of other innovations. The key question is not whether these things could matter but whether they are going to be implemented by Canadian management. For the most part, Canada has been slow to adopt new technology. The United States and Japan are far quicker. So in the short term, the Canadian situation could become worse because of this technology.

RICHARD HARRIS: There is some evidence to support the hypothesis that flexible manufacturing systems will reduce the importance of scale in production. Obviously, if that happens, small countries would be more advantageously situated. And if the estimates of the economies of scale were smaller, the gains to be had from realizing greater scale would be smaller. But whether this situation is going to occur, nobody knows. So far, industrial concentration in trade world wide has gone up, not down, although the reason may be other than economies of scale.

The relationship between trade agreements and international direct investment

A.E. Safarian

One of the questions that arises in considering new trading arrangements is their effects on the activities of multinational enterprises. If, for example, Canada and the United States negotiate a free-trade or some other trade agreement, what will happen to direct investment flows and to the development of subsidiaries through internal funding? Given the major role of MNEs in Canada and their growing influence elsewhere, it is surprising that there are few studies bearing directly on the subject and no major study for Canada.[1] These comments are a preliminary attempt to state and assess the relevant ideas. A great deal of work will have to be done before one can speak more convincingly on some points.

An obvious limitation of any such presentation is that we do not know what kind of trading arrangement will be negotiated; hence we must be guarded about the likely effects. For this paper, I assume that what is being discussed is a free-trade arrangement between Canada and the United States that exempts a limited number of industries: after a transition period, tariffs between the two countries disappear, and there is national (that is, nondiscriminatory) treatment of the firms in the two countries so far as nontariff barriers are concerned. Each country is assumed to maintain its separate protective devices against third countries, which do not retaliate, and each maintains considerable power to influence industrial development short of direct trade distortion. The reader is invited to make any modification desired and to follow through on the probable effects. I recognize that

Professor Safarian is a member of the Department of Economics, University of Toronto.

some prefer to speak of 'fair trade' or 'securing and enhancing market access'; these euphemisms may more accurately describe the final outcomes.

At the outset, it is important to note that it is the MNEs' response *to the free-trade arrangement* that interests us. Obviously, a great many other economic variables and policies can change and affect such firms' investments. It is also important to note that two distinct phenomena need to be considered: 1) first-time 'green fields' investments or acquisitions abroad, and 2) the ongoing activities of existing subsidiaries in each country. Finally, at least three types of MNEs, actual or potential, need to be considered: 1) US MNEs with subsidiaries in Canada, 2) Canadian MNEs with subsidiaries in the United States, and 3) third-country MNEs with subsidiaries in either Canada or the United States.

IS DIRECT INVESTMENT A SUBSTITUTE FOR TRADE?

There is a fairly widespread view that a free-trade arrangement would lead many US MNEs to phase out major parts or all of their Canadian operations and serve Canadian markets from their more efficient US plants. This view is buttressed by the idea that many US MNEs located in Canada to avoid Canadian tariffs or, more recently, various nontariff barriers. In this view, imports of final goods are substitutes for direct investment; impediments to such imports stimulate the movement of the agents of production to the industries involved, while the removal of impediments dries up direct investment and perhaps also leads to disinvestment.

Following this theory alone, the results of free trade can be predicted as follows. Removal of impediments to imports by both the United States and Canada would reduce new investments and acquisitions in *both* directions – that is, by US firms in Canada and by Canadian firms in the United States. Over time, it would tend also to lead to closure or sale of existing subsidiaries that are heavily reliant on protection for their existence. Both countries would see some extra investment from third countries; the elimination of trade impediments between the two countries would divert third-country trade, which some affected firms would attempt to retain by direct investment rather than by reducing their export prices.

I have no doubt that if substitution were all that was involved, the outcome of a free-trade agreement would be a net reduction in capital investment and stock in Canada. The absolute volume of US-owned business capital in Canada is much larger than the volume of Canadian-owned business capital in the United States, and a substantial proportion of the former is in relatively less efficient secondary manufacture.

There are good reasons, however, for assigning this determinant a smaller weight than others.

The stringent assumptions of trade theory

First, the theoretical basis for the idea that trade and factor movements are substitutes rests on quite stringent assumptions in trade theory, such as homogeneous factors of production, homogeneous products, and identical production technologies in the two countries. Once these assumptions are relaxed, factor mobility is no longer a full substitute for trade.[2]

Subsidiaries, licensing, and trade

More fundamentally, the most widely accepted theory of MNE activity suggests these firms go abroad through subsidiaries, rather than through exports or contracts such as licences, because they can most profitably exploit certain types of assets by using the organizational form of the subsidiary. Each of the three forms has advantages. The subsidiary is often preferred in a variety of circumstances: for example, where technology is difficult to transfer at arms length, where quick imitation is feared, where bargaining with independent suppliers or purchasers is costly, where transfer pricing is feasible, and where after-sales service is critical to customer acceptance and difficult to contract out. We are speaking of a world of larger firms that have an impact on one another, that face a great deal of uncertainty in the process, and that frequently produce differentiated products. It has long been suggested that the greater the interaction among firms, the more the likelihood they will use subsidiaries or at least some form of contract rather than trade.[3]

Statistical evidence has long suggested that tariffs have been a significant factor in persuading MNEs to exploit their assets through subsidiaries rather than exports. That evidence is not unchallenged, but some weight must clearly be attached to it.[4] More recent evidence suggests that other forms of incentives, such as subsidies or performance requirements, can also be effective in many situations (Guisinger, forthcoming). It is quite clear, however, that other variables affect the decision to locate abroad. Exchange-rate changes that persist over a period can have the same effect as tariffs or nontariff barriers. Transport costs for inputs and outputs help determine the distribution of direct investment internationally, much as they do for plant locations within a country. Where product differentiation is great and advertising significant, competition by MNEs often leads to serving foreign markets by local production rather than by exports. (Indeed, the products produced at home and abroad may not be the same, if only because regional markets differ significantly both within and across countries.) The decision to locate abroad or to export is influenced also by the degree to which scale economies have been exploited at home. In brief, all the evidence suggests it is a mistake to think of the decision about foreign direct investment as a one dimensional one.[5]

It is also evident that even if tariffs played an important role in the decision to establish a subsidiary half a century ago or more, they may have less to do with the present-day operations of that firm.

Specialization

The most important point, however, is the change in production structure that the removal of tariffs and nontariff barriers would allow. There is a mountain of evidence that Canadian and US tariffs, combined with oligopolistic competition in the relatively small Canadian market, have led to an inefficient structure of production in many Canadian manufacturing industries. The emphasis is often on product diversity with consequent short runs and high unit costs. With access to a larger market guaranteed and with increased import competition, MNEs and domestic firms would have the incentive to drop some product lines and specialize in others so as to achieve efficient scale. Just where they would choose to do so would depend on many variables, beginning with the degree to which scale economies exist in a given sector and how far the firms have gone in exploiting them. Other determinants include wage rates (adjusted for the exchange rate), transfer costs for inputs and outputs, the competitive pressures faced in the US market, and the flexibility and initiative of Canadian business, labour, and government in coping with all of this. I include government here because various aids to industrial adjustment and growth, even though constrained, will remain in any trading arrangement, as the experience of the European Common Market clearly demonstrates.

It is difficult to make predictions about these kinds of adjustments except at the firm and industry level. All we can point to is the fact that the process is already well under way – witness the degree of specialization in trade that occurred in the 1970s (Economic Council of Canada 1983, part C). The growth of intracorporate trade and the fairly widespread industrial penetration by Canadian MNEs in the United States also point in the same direction. I am not suggesting that free trade would not bring divestment of subsidiaries in sectors where comparative costs are high and would remain so despite specialization. The major studies on the effects of a free-trade area all point, however, to Canada as a competitive source of a wide range of manufactures once the possibilities for specialization and scale economies are exploited.[6] Wolf (1984) has analysed the actual processes involved in international specialization within MNEs. He has also examined the circumstances in which there arise world product mandates – that is, production specialization accompanied by responsibility for research and development and marketing by the subsidiary. The point here is that the onus of proof must rest on those who believe that neither Canadian nor foreign firms – not even those that are already on the spot with existing facilities – would utilize the opportunities offered by free trade for rationalization.

Canadian-owned independent firms and subsidiaries

Subsidiaries of MNEs already have potential or actual foreign marketing ties and access to financial and technical support for reorganization along specialized lines in a multinational setting. Assuming such a firm decides to specialize production, rather than to stay as is or to divest, the changeover should be relatively quick. By contrast, many Canadian-owned firms that are not now MNEs would find the challenges to be great. In the process of moving to more specialized or differentiated production, they might prefer to use licensing to get access to US technology. Entry to the US market might begin with free trade, but competition with firms already established there could impose major challenges. It is not unlikely that some Canadian-owned firms would decide to enter by direct investment, despite the absence of trade barriers. They might also, while in the process of reorganizing production, making new marketing arrangements, and generally meeting competitive pressures, find themselves taken over by a Canadian or US multinational. Thus, although it may sound paradoxical to those who think of trade and investment as substitutes, the reduction of trade barriers might well lead to increases in direct foreign investment on both sides of the border for a time.

Although independent Canadian firms would be at a disadvantage in some respects, they could use a variety of strategies to overcome the problems noted. Moreover, they would not be constrained by some of the limitations placed on the subsidiaries of MNEs. Indeed, as already noted, increased specialization and trade are well underway in manufactures, and Canadian direct investment in the United States has grown rapidly across a broad front. Canadian-owned firms have responded more strongly than foreign-owned firms to expanding trade opportunities by entering and exiting from industry (Baldwin and Gorecki 1983a, 120-4), presumably in part because the latter firms have the alternative of intra-MNE specialization.[7] The best evidence available suggests that plants owned by US MNEs were more specialized than comparable Canadian-owned plants in the early 1970s but that this gap had been greatly narrowed by the late 1970s (Baldwin and Gorecki 1983b, 54-65, 109-116).

Canadian MNEs

The extent to which Canada has become a home country for MNEs has not always been appreciated, mainly because of the lags in publishing data on the stock of such investments and the undue attention given to a few sectors, such as real estate. Put briefly, preliminary estimates supplied by Statistics Canada indicate that the stock of resident-controlled outflows plus retained earnings abroad, measured in book value, nearly doubled from $20 billion at the end of 1979 to $39 billion at the end of 1983. During the same period, the equivalent stock of foreign-controlled capital in Canada rose from $54 billion to $73 billion. The ratio of the outward stock to the inward has risen rapidly from 25 per cent in 1974 to 37 per cent in 1979 and 54 per cent in 1983. This is an extraordinary development on the outward side when one notes that, until recently, the foreign-controlled stock of capital in Canada was the largest in the world in absolute terms.[8] At the end of 1981, moreover, only 13 per cent of the book value of the stock abroad was in finance and real estate. Manufacturing, including the processing of primary goods, accounted for 47 per cent, mining and smelting for 10 per cent, petroleum and gas for 18 per cent, and merchandising, utilities, and other industries for the remaining 12 per cent (Statistics Canada cat. 11-001E).

I have no doubt that some significant portion of this investment is spurred by impediments to imports in the United States. It is sometimes argued that since US tariffs after the Tokyo Round cuts are all in place will average only about 5 per cent, the great bulk of our exports will enter duty-free. Yet averages hide a considerable dispersion of actual rates, and potential trade that is blocked by a tariff never appears in the statistics on trade, duty-free or otherwise. Moreover, nontariff barriers are increasingly blocking trade and attracting investment. The threat that competitors will invoke a tariff or other barrier is often enough to convince a firm to locate a plant abroad even if there is no barrier currently.

No detailed quantitative study of Canadian direct investment in the United States exists as yet to test all of this, although there are many particular examples. It is clear, however, that using MNEs to realize profit opportunities in that market is very much part of the process described earlier. The analyst must go beyond impediments to trade and think more broadly of firms' attempting to exploit their particular advantages and frequently finding that the MNE form of organization is the best way to do so.

Trade and investment as complements

More generally, the experience of the international economy and of established free trade areas suggests that trade and investment expand together. One reason is that, although subsidiaries are set up in part because of impediments to trade, they also trade with their own affiliates, purchasing and selling finished goods and components. This reflects specialization by affiliated firms at the same stage of production and also vertical integration of different stages, used in part because affiliates act as secure and knowledgeable distributors.

Another reason trade and investment expand together is the typical reactions of firms in a market to the threat of the entry of imports, particularly to a major potential change brought on by a free-trade arrangement. In such circumstances, local firms can use a host of methods to attempt to deter entry by efficient foreign producers. One, of course, is to penetrate the foreign competitor's home market with exports, using differentiated products. Another is to use a whole series of competitive tactics designed to prevent or limit entry. A third is to buy out the new competitor, or, alternatively, be bought out by it. Where competition laws permit, some (at least tacit) market-sharing may result. Once again, we note that the Canadian subsidiary of a foreign-owned MNE might have some advantages in this process, in that the parent is already in the US market. As noted, however, many Canadian-owned firms have penetrated the US market with subsidiaries as well as exports in recent years.

As evidence of the complementary expansion of trade and investment, we note that intracorporate trade has expanded significantly in many US MNEs (though not as quickly, outside automobiles and petroleum, as had originally been thought) and that much of the increase has been in finished as well as intermediate products (Economic Council of Canada 1983, 95, 135; Lavergne and Helleiner). The experience of the European Economic Community is even more revealing. It is well recognized that the disappearance of internal tariffs and the growth of the EEC market spurred a good deal of direct investment from outside the EEC, notably by US firms. Since tariff discrimination against non-EEC countries was involved, this result might be taken as underlining the view that trade and investment are substitutes. A closer look indicates, however, that direct investment by EEC multinationals themselves also expanded rapidly within the common market, despite the disappearance of internal tariffs. Moreover, the manufacturing sectors where EEC direct investment spread most were the ones where scale economies were highest and hence trade links should have been strong. In part, this unexpected outcome was because of nontariff barriers to trade. In part, it reflected attempts by domestic firms to maintain market shares, often by acquiring the potential foreign exporters. This, in turn, led to counteracquisitions in order to get around such attempts to restrict firms' exports. It is interesting to note that firms based in the smaller EEC countries were the most aggressive in acquiring such 'fifth-column' investments designed to penetrate large markets being defended by the established firms. (For more on EEC MNEs, see Franko 1977.)

RELATED INVESTMENT ISSUES

Nonmanufacturing sectors

Most of what I have said has dealt with manufactures, the sector in which concerns about the effects of free trade on investment seem to be greatest. Having the trade arrangements also cover other sectors would seem to tip the scales in Canada's favour so far as investment is concerned. Most studies suggest that Canada's comparative advantage is generally (though not uniformly) larger in primary resources and primary manufactures, at least given present impediments to trade and market size. Actual or threatened barriers to upgrading for export are one of the factors limiting further processing in Canada by these sectors. Presumably, a free-trade area would encourage investment in Canada in these sectors, subject to what was said earlier about the transport and other determinants of such investments. Such market penetration, actual or threatened, would also presumably lead to defensive direct investments in each direction.

It is much more difficult to make general statements about the services sector, given the variations in government protection (both here and in the United States), natural protection, widely different capital and skill intensities, and other differences. Nor is it clear how many such sectors would be among those exempted from a free-trade arrangement.

A potential problem for the sectors going through restructuring is the high cost to them of those service sectors that are relatively inefficient. Presumably, there would be considerable pressure on the latter to rationalize and to try to follow MNEs abroad, since these sectors would otherwise lose a good deal of business.

Other determinants of investment

Much of what I have noted applies to a transition period in which adjustments would be made to existing plants because of the dismemberment of impediments to trade. A larger issue in the longer term is where actual and potential MNEs – whether from Canada, the United States, or elsewhere – would locate to serve the free-trade area or other markets. The capacity to attract new investments, so as to revitalize old industries and capture new ones, depends on a range of market, cost and government policy variables that go well beyond the scope of this comment. It is worth noting, however, that considering the general environment puts tariffs and nontariff barriers into (a diminished) context as determinants of investment patterns. In brief, free trade is only one, albeit an important, aspect of a policy designed to increase competitiveness and reduce susceptibility to shocks in our largest foreign market. It will not succeed in attracting new investments over time if other policy variables are damaging to investment.

It is apparent that there are important offsetting forces to any encouragement to divestment free trade would give MNEs. These offsets, which are substantial, include: rationalization by US firms already in secondary manufacturing in Canada so as to take advantage of the large and secure US market; gearing up by Canadian-owned secondary manufacturing firms for the same purpose; expanded investment in primary resource processing; and expanded third-country investment in the enlarged Canadian-US market. Given all of this, it is difficult to believe in an outcome of net divestment.[9] The investment that would remain, moreover, would not levy a permanent tax on consumers in the way that tariff-induced investments often do. Finally, once one takes account of oligopolistic reactions to market entry, as noted, direct investment may well increase both ways for a time.

Adjustments to net capital outflows

What happens if this analysis should be incorrect and a free-trade agreement resulted in substantial net divestment by MNEs in Canada in addition to substantial net outflows by Canadian MNEs? At least three adjustments should constrain the damage.

- Other things equal, the foreign exchange value of the Canadian dollar would fall, tending to discourage capital export. An exchange rate that was lower for any significant period (for this or other reasons) would also tend to enhance Canadian locations for export.

- Real asset prices would fall in Canada with such a net exodus. Such assets are only part of what is needed for modern production and distribution in a multinational context. At some price, however, others would be tempted to find if they could operate them, alone or, through various contractual devices, with former owners or other MNEs.

- To the extent capital and technology departed, wage rates would fall in relative terms, and more labour-intensive secondary manufacturing industries would be favoured. It is not clear just how relevant this type of adjustment is to direct investment, but, to the extent it occurs, it reduces capital outflows.

Finally, the balance-of-payments constraint should be noted: If there were a net capital outflow, Canada would have to be generating a current account surplus. That could occur, of course, in ways that were more or less painful, depending on the types of internal and exchange rate adjustment that occurred.

POLICY ISSUES

It is beyond the scope of this paper to analyse the policy ramifications of MNE investment activities and free trade, ramifications that clearly overlap with the trade-policy aspects. I will close, nevertheless, by noting briefly a few policy issues closely related to direct investment. One is the future of review agencies, such as FIRA or Investment Canada. The latter will involve more streamlined procedures and a more welcoming stance than the former. Nevertheless, it will still involve a highly discretionary approach to mergers from abroad or by foreign-owned firms in Canada, and it will look at about two-thirds of the investment values now covered by FIRA, using criteria of benefit that will be virtually unchanged. It is difficult to imagine any trading partner agreeing to the continuation of such screening on one side only, as the appeal to GATT on FIRA and the US reciprocity legislation of 1984 clearly show. As in the case of fiscal incentives closely tied to trade and to trade-related investment, some agreement on such regulatory approaches to investment would have to be worked out.

The degree of foreign control of industry has attracted government policy on a wide front in the past, both in Canada and elsewhere (Safarian 1983). In the short run, the types of oligopolistic response to trade penetration noted earlier could well increase both foreign ownership in Canada and Canadian ownership in the United States. In the longer term, two developments should more than offset this situation. First, Canadian-owned firms with one or a few plants would be less likely to merge with MNEs, since they could achieve efficient scale and related headquarters functions independently – a result foreseen by Eastman and Stykolt (1967, chap. 4). Second, with increased efficiency the capital-to-output ratio would fall in some sectors, thus reducing reliance on foreign capital to finance investment (Wonnacott 1975, 101-3). Although direct investment is not closely associated with capital scarcity, to the extent that capital and technological change go together this phenomenon could lessen the degree of foreign ownership. Both these points are likely to be less important than the fact that Canada's share of world direct investment has fallen sharply over time, as has the degree of foreign ownership of industry since about 1970 (Safarian 1983, 14-20).

A free-trade agreement between Canada and the United States would require the former to clarify the uncertainties in its competition policy, especially on mergers, and both countries to work out some international aspects of competition policy. Some interesting challenges would also be posed for Canada's policies on research and development, which seem geared more to doing such work in Canada than to assuring that best-practice technology is quickly and widely available. Some of the rationalized subsidiaries would carry increased responsibilities, including R&D, for their narrower product lines, but others would find they had best- or better-practice technologies but reduced decision-making powers.

The really critical problems would be those that overlapped with trade. In particular, with government restrictions on the flow of goods removed and with capital and technology freer to move, the adjustment would fall on less mobile labour groups (and on natural resources). This is more particularly the case since what is envisaged is a free-trade arrangement, not a common market in which labour migration between the countries involved could take more of the adjustment (Hufbauer, 1974). In the end it would be the ability to handle issues such as these and to maintain a favourable investment policy in Canada in other respects, that would determine how well a trading arrangement would work.

NOTES

1 Burgess (1984) contains an excellent brief analysis of the issues that was helpful at several points in this paper.

2 Mundell (1957) first demonstrated the conditions under which trade and factor movements are substitutes. Purvis (1972) showed they are no longer so when one relaxes the assumption of identical production technologies in the two countries.

3 Caves (1982, chap. 1) outlines the development of this position, which is central to theory on MNEs.

4 Caves (1982, 40-5) summarizes the various studies for Canada and

other countries. Scaperland and Balough (1983) also confirm the significance of tariffs, along with other variables.

5 Surveys of MNE decisions to invest abroad regularly turn up a variety of market factors (to take advantage of a large and/or rapidly growing market abroad, to follow a customer or competitor abroad, to market more effectively), cost factors (to save on the use of local materials, to reduce transport costs, to get access to lower labour costs or to foreign techniques), and the desire to take advantage of various government incentives, as well as the surmounting of government impediments to exports.

6 The major literature on this begins with Eastman and Stykolt (1967). See also Wonnacott (1975), Wonnacott and Wonnacott (1967), Economic Council of Canada (1975), and Harris and Cox (1983) among others. For further studies, some with qualifications, see *Canadian Public Policy* (1982).

7 It has also been suggested that there was more scope for rationalization in the domestic sector and some domestic penetration of the foreign-owned sector.

8 Data on stocks of capital supplied by courtesy of Statistics Canada.

9 On a closely related point, Harris and Cox (1983, 146, 151) conclude that multilateral free trade would increase the size of the manufacturing sector in Canada.

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Discussion

QUESTION: Another point that might be mentioned in this context is that decisions on investment are not always dictated entirely by economic considerations. The determination of a particular management group to achieve an objective is also an important factor. I suggest there are many management groups that are happy to be in Canada, that are largely made up of Canadians, and that are strongly determined that the organization they serve should maintain significant manufacturing in Canada.

ED SAFARIAN (University of Toronto): Yes, my paper distinguishes between established companies and new entrants. Established companies have varying degrees of sunk costs and of commitment. Some of them have already gone a substantial way towards rationalizing production; others have gone part way and will go further.

QUESTION: I notice that you, like almost every speaker today, pointed to the role of government in facilitating adjustments after free trade was put in place. I see two problems here. First, the record of government policies directed towards adjustment assistance in Canada and the United States shows that they have not been terribly effective. Second, the United States has shown it is not very sympathetic towards policies of support for either business or labour.

ED SAFARIAN: I think you are quite right about the mixed record of government in providing adjustment assistance. The reason is the political pressure and immediate problems of the labour-intensive sectors. But I think the game would change under a free-trade agreement. There would be a set time frame in which the adjustment process would have to take place. That would give the government considerable incentive to make sure it was not left with all sorts of contingent liabilities that went on forever. The pressure on government – as well as on business – would be quite different from what it is now.

Canada and the United States do differ on attitudes towards support for industry. I think that difference goes beyond the present government in the United States, and it is simply going to have to be accepted as part of the dissimilarity of the two countries. However, it is worth noting that the difference is not as large as some people think; there are some things the US federal government doesn't do that the state governments do.

The role of government in export promotion

Arthur Smith

The theme of this conference, Canadian Trade at a Crossroads, is timely and important. After the Depression and the Second World War, my generation grew up with the slogan, 'peace and prosperity'; a central objective was the re-establishment of open, orderly, and expanding international trade. We understood that the constraints imposed on international commerce in the 1920s and 1930s had been powerful contributing factors to the economic insulations, and the closely related political isolations that had led to the loss of prosperity in the 1930s and the loss of peace in the 1940s.

It is widely accepted that genius in outward-looking leadership during the late 1940s and 1950s led to a re-established prosperity that was largely based on increased scope and freedom for international flows of goods, services, and investment. Yet in recent years there have been disquieting and increasing tendencies to constrict such international flows, either directly through trade-protecting, insulating actions or indirectly through a variety of trade-distorting policies and practices. We are, therefore, much in need of a reappraisal of the present regime of international trading and commercial policies. In fact, we now need to look well beyond to more fundamental issues of policy harmonization in a world that has once again begun to grow nationalistic and insular through diverse and inconsistent national-policy actions.

Dr Smith is chief executive officer of the Canadian Labour Market and Productivity Centre and a former senior adviser to the Ontario Economic Council.

SOME BACKGROUND AND SOME HISTORY

This part of the conference program is focused on the role of government in export promotion. Before I address that topic, let me set out some background on a few issues that have helped to shape my personal perspective. There is little need to recite the sad litany of our economic problems during the past decade: high inflation, high unemployment, chronic large deficits, very high real interest rates, a slowdown in the trend rate of growth, and an accompanying accentuation of economic and financial instability.

With these difficulties have come enormously increased efforts to try to stabilize economies and to rekindle better growth in real earned income and wealth. One of our underlying problems, however, is that we have not been able to develop adequate explanations, concepts, and theories about many of our difficult predicaments. In the late nineteenth century, economists developed a powerful set of interrelated theories that were loosely called neoclassicism. Its central focus was on markets, and its central theme was that even if imperfect in many ways, markets would tend to move us continually towards new forms of equilibrium. There was, of course, great attention to theories about imperfect competition, monopoly, oligopsony, oligopoly, and all other market imperfections. Therefore, much government-policy thinking was devoted to how to make markets work better.

Then came the Depression of the 1930s, when it no longer appeared that we could count on markets to provide both growth and stability. In these conditions was born a new set of theories, loosely called Keynesianism, whose theme was that fundamental deficiencies in market economies require major interventions by governments. In particular, they must undertake major countercyclical changes in monetary and fiscal policies to stimulate slack economies in times of recession and to restrain overexuberant economies in times of excessively rapid expansion.

The Keynesian theories and their derivatives began to run out of steam in the middle of the 1960s. More recently, new attention has been focused on other theories – monetarism and supply-side economics. I have two points to make about them: they are not new theories, and they are essentially theories about *long-term, trend* developments in economies. Yet they too appear to be inadequate for coping with the most basic problems of our times, the problems of structural changes in markets, production, and employment – problems associated with accelerated change in product and process technologies and the pitiless intensification of competitive pressures from both existing and new centres of productive capabilities.

I recall a good economic forecast made by Joseph Schumpeter in a classroom in 1948 when I was a student. He predicted then that the 1970s would be a decade of slowdown and the 1980s a decade of intense economic problems. In my view, recent analysts have not given adequate attention to his theories, conceptions, and perceptions, in particular those parts that focused on structural changes, such as the sharp slowing in the growth (or even the decline) of substantial industries and organizations, the emergence of industries based on new technologies and new markets, the appearance of small industries that do not yet have the power to create huge markets and massive new employment, and shifts from old, once strong centres of economic activity to new centres of competitive performance.

I believe that Schumpeter's views of the world provide us with a great deal of insight into the difficulties that we are now enduring. They also help to explain the new emphasis in such fields as industrial policy, international trade, and financial policy. Against the background of slower growth, we are seeing, at least in some measure, a revival of pressure to increase protection, along with a great variety of increased efforts by nations to promote exports.

THE VARIOUS ROLES OF GOVERNMENT

The subtitle for this part of the conference program is 'Trade Liberalization and Competitive Markets versus Government Assistance to Exporters versus Broad Productivity Programs'. My general comment is that the word 'versus' is not appropriate. To achieve good trade performance (and that is vitally important for a country such as Canada), we need all three of these elements. We need powerful efforts, on both our own part and that of our major trading partners, to foster an open, liberalized trading world. We need to be diligent and aggressive to assure competitive Canadian producers fair and consistent access to foreign markets. Conversely, to help Canadian producers maintain a good competitive performance, we need to assure competitive foreign producers fair and consistent access to our markets. We also need appropriate assistance from government to support and enhance Canadian producers' competitive capabilities, both when they are threatened by the anticompetitive actions of foreign nations (for example, by foreign subsidization of export financing, insurance grants, and so forth) and when there are opportunities to foster long-term competitive development and strengthening of Canadian export capabilities.

In my view, one of the best illustrations of good government assistance is the current federal program that covers half the costs of Canadian exporters' travel abroad to develop significant new markets for their products. It also pays half the costs of potential foreign customers' visits to Canadian producers. The personal exchanges made possible by on-site discussions have, I think, become more important than ever in our rapidly changing world.

Another illustration of relevant government assistance is the work of the Export Development Corporation, which plays a significant supporting role in helping Canadian firms to meet international competition in export financing, insurance, and some loan guarantees, working in various co-operative ways with other export-financing institutions, such as the Canadian banks.

The search for improved productivity

Perhaps the most important need of all, however, is for government to encourage increasingly good productivity performance in Canadian industries. Improved productivity is not the only factor that can influence the international competitiveness of Canadian producers – changes in exchange rates and a great variety of other conditions shape this capability – but a strong trend of productivity growth in export-oriented Canadian enterprises is highly relevant to the attainment of relatively low unit costs of production and hence to the export achievements of such enterprises.

In this context, the term 'productivity' must be understood in a broad, complex sense. High productivity-performance capabilities are irrelevant without promising and profitable markets for the output. Productivity concerns not merely the quantity of output but also its quality and the timeliness of delivery, servicing, and other relevant activities. Producing a large quantity of output in relation to labour, capital, materials, and other inputs is not a great achievement if product quality is generally poor. Similarly, the successful organization of production, the development and effective use of outstanding managerial skills and practices, and the stimulation of enthusiasm and creativeness among employees are of enormous importance.

Some of these latter elements in successful productivity performance are now, fortunately, being given much greater attention within the nation's workplaces.

In recent years, Canada has suffered one of the industrialized world's poorest trends of general productivity growth in basic export industries, as well as in many import-competing industries. We have not only not kept pace with our most important trading partner, the United States, but we have also lost significant ground relative to other maturing industrial economies in Europe and Japan. Simultaneously, we are being subjected to sharp thrusts of new competitive pressures from the newly industrialized countries, especially those of the Pacific Rim.

During the past decade, we have, of course, had many serious issues to worry about besides the virtual halt of our productivity growth. But it is of critical importance for Canadians to remember that many of these are not so much problems in their own right as symptoms or effects of the slowdown in productivity. We must also recall that, to a very large extent, the long-term development in Canada of a high standard of living, high real incomes, and high average real wealth has been the result of our great achievements in exporting. Looking to the future, I strongly suggest that our prosperity, employment, real incomes, and wealth will continue to depend on effective, large-scale, and diversified exports.

It will be hard for us to continue to fight uphill battles for exports in a world that may have lost its underlying momentum for growth in output, employment, and trade and that has developed sharp and pressing competition for so many types of products. But it is essential that we maintain an impressive commitment to being successful exporters, that we organize our thinking, our industrial structure, and our innovativeness to the task of improving our export performance.

Government support for Canadian exporters

R. Lorne Seitz

The subtitle of this session, as announced by the conference organizers, is 'The role of government in export promotion: trade liberalization and competitive markets versus assistance to exporters versus broad productivity programs'. To some extent that title appears to suggest that governments must make choices among these various strategies. Frankly, it strikes me that, to the contrary, governments must not choose among them but instead must determine appropriate methods of blending all three together. In my view, no overall Canadian trade strategy can be successful without including all of those components.

Without trade liberalization, we run the risk of, at worst, losing the markets we currently have or, at best, not securing access to additional markets. We also stand to watch our own industries adjusting at a slower pace than others. Without broad productivity programs, we run the risk of slipping further behind in the race for that continually moving target – international competitiveness. Without some measure of government assistance to exporters, we are asking Canadian exporters to enter the game against competitors who have one or two aces already in their hands.

My remarks today will touch upon all three strategies. However, given the fact that this conference is investigating the issue of trade liberalization from every conceivable angle, I won't dwell upon that topic to any great extent. Instead, I will concentrate on government

Mr Seitz is senior vice-president of the Canadian Chamber of Commerce.

assistance to exporters or, to use another phrase, government support for exporters.

CREATING AN ENVIRONMENT FOR TRADE

Let me first state that the motivation for exporting and the factors contributing to success in international markets lie with Canadian companies themselves significantly more than with government. Governments have a broad role to play, particularly in creating a sound economic environment and in working for the removal or reduction of obstacles that exporters face. But to assume that government support programs by themselves will make Canadian companies competitive in international markets is to ignore reality. Assistance programs to exporters can be extremely useful and may provide the slight edge that enables a Canadian company to win a particular contract, but let's keep such programs in perspective.

I am skeptical of the prospects for success of any single, all-encompassing trade strategy or grand design. Realism dictates a multifaceted approach that includes the creation of new policy instruments and the refinement of existing ones in a manner that is mutually reinforcing and that enhances the ability of Canadian industry to compete at home and abroad. Further, these policy instruments must be flexible: they must be able to meet the needs of exporters according to various criteria, such as the degree of export sophistication of companies, the types of products and services, and the intended markets.

I am also skeptical of approaches that seek to identify winners and losers and to establish industry-specific policies based upon someone's subjective decision or crystal-ball gazing or, even worse, the strength of industry lobbies or political interests. Frankly, the market serves to pick winners and losers in a very objective manner, and we should be extremely careful about interfering unduly in that process. (This statement is not meant to suggest that there is no room for programs or policies such as those supporting research and development activities or productivity enhancement. Such programs and policies provide for the creation or maintenance of a sound basis of competitiveness for industries generally.)

We should also guard against slipping into a mind-set that considers only merchandise exports, ignoring services. Programs and policies based on that narrow premise are not only short-sighted but also short term. Services are already an important dimension of international trade and will grow considerably in the years to come.

Trade policies

To address the issue of trade policy, I cannot conceive of a trade policy for Canada that accepts or advocates increased protectionism or even the status quo. That statement applies not only to our approach to other markets but equally to our own policies. Economic self-sufficiency and isolation are simply not viable options for Canada. Frankly, I do not believe the status quo is an appropriate policy. Canada as a whole stands to gain much more from free access to foreign markets than any particular industry stands to gain from protection.

At home, protection keeps productive resources tied up in uncompetitive industries, delaying adjustments rather than encouraging them. In addition to imposing specifically protectionist measures, our governments often succumb to requests for supplementary grants, soft loans, and guarantees, and taxpayers are powerless to do anything but watch their money go down the drain if, as sometimes happens, the firms receiving such assistance fail to make good on the promises that justified the grants. Throughout all of this, the interests of consumers are usually given short shrift.

Adjustment, it appears, only takes place when industries are exposed to competition. So-called breathing space seems to be viewed by some industries as a time to build a case for more breathing space. The temporary tends to become the permanent. I won't argue against the use of any and all measures, such as quotas, to give an industry a chance to adjust to fairly rapid changes in international competitive circumstances. But these measures should have a fixed phase-out formula built in at the very beginning, a formula that allows imports an increasing market share throughout the term of the measure and that includes conditions and a time limit fixed by legislation and not subject to relatively simple change (such as an order-in-council). We should apply that formula to existing restrictive measures.

In trade negotiations, I'd like to see us pursue our goal of trade liberalization and access to markets on every front. Let's attempt to achieve the maximum attainable in multilateral negotiations, and let's try to achieve even more on a bilateral basis, particularly with the United States. Indeed, a case can be made that many of our industries currently are in a much better position to compete with the United States than with other countries. Therefore, if, as many believe, all of our industries will have to compete in a world marketplace in the long run, the US market is a good place for transition. If we can't compete in the US market, where can we compete? If we can't do it now, when will we? All we can do is to delay the inevitable. And when the day comes, our inaction now may have placed us in a worse position to compete.

Increasing competitiveness

Although trade policies are important to international competitiveness, they are not the only answer. Competitiveness arises from a combination of factors, such as technological innovation, management skills, labour morale, capitalization, ownership structure, and the regulatory environment, to name but a few. It is the combined operation of these factors that leads to competitiveness, and one must be wary of purported solutions to dilemmas of productivity that tinker in one area while ignoring the rest. In this regard, there is much that needs to be done in Canada, and it needs to be done by all Canadians working together in a conscious way to improve the competitiveness of Canadian production.

Let us look, for the moment, at just one or two areas where we could make improvements. First, it seems to me that a major factor in international competitiveness is now and will be in the future the level of research and development undertaken by companies and by countries. That observation is applicable to all industries, not just those considered to be in high-tech fields. Policies and programs, preferably tax based, that encourage and support increased R&D by Canadian companies are particularly appropriate mechanisms to help build the type of internationally competitive firms that will serve Canada's interests in the future.

Such policies or programs can serve several purposes. In addition to creating stronger, more technologically advanced companies, they can also contribute to the winning of global product mandates by Canadian subsidiaries of multinational enterprises. Contrary to popular wisdom, I doubt that most such mandates are given to subsidiaries by the parent MNE. Rather, they are probably first won by the subsidiary and then blessed by the head office. If we want to help Canadian subsidiaries win those mandates, we should be looking towards policies to provide them with arguments for carrying out certain actions in Canada, policies such as favourable treatment of R&D expenditures.

R&D policies could also be tied to exports in such a manner that companies that increased their exports from year to year qualified for somewhat larger R&D incentives. This approach might also be a way to provide an incentive to aggressive exporters without running afoul of the rules of the General Agreement on Tariffs and Trade that restrict tax incentives for exports.

In addition, we must be careful that legislation introduced for domestic reasons does not create impediments to the achievement of international competitiveness. For example, competition laws to restrict mergers or co-operative activity by companies could hinder the creation of world-scale enterprises capable of competing effectively on an international level.

DIRECT SUPPORT OF EXPORTS

Let me turn now to the matter of government's direct role in support of exports. At the outset, I think we should recognize that the requirements of exporters differ quite significantly depending upon their size, level of export sophistication, and type of product or service. Small companies require information and perhaps help in market development. Larger companies, on the other hand, usually have well-developed sources of information and can carry out market development quite well on their own. They are more likely to seek support in the way of financing or political or diplomatic assistance. Similarly, manufacturers and service companies may require different types of programs than do resource companies.

Furthermore, selling in various markets of the world requires different kinds of support programs. The assistance that companies require vis-à-vis Asia or Eastern Europe can be quite different from what they might seek for the United States or Western Europe.

It is, therefore, dangerous to assume that one or two particular approaches to export development will satisfy the requirements of all exporters. When I hear an exporter say, 'Forget about information programs, forget about trade commissioners, forget about the Program for Export Market Development. Just provide us with competitive financing', I am fairly sure that person represents a large company with a well-established international network, probably a manufacturer of capital equipment. The statement may be accurate for one type of company, but I doubt it applies to most Canadian exporters whose needs, although they may include attractive financing, probably also involve up-to-date market information, someone on site to make initial contacts for the company, and perhaps some assistance towards the cost of market development.

Thus, to provide direct support to exporters, we need programs that fall into four categories:

- Collecting and delivering information.
- Providing on-site assistance.
- Creating a positive image of Canadian capabilities.
- Providing market development assistance or incentives, including export financing.

I might add that although I see such programs providing positive support for Canadian exporters, I do not see some or all of them as the exclusive preserve of the federal government. Indeed, the private sector and the provinces should be playing a much greater role in these kinds of programs than they do at present.

INFORMATION PROGRAMS

The first item on the list is information programs. I'm referring here to information on particular markets and their characteristics, on opportunities for particular products or services, on the competition, on economic and political developments in foreign markets that might have an impact on Canadian exports, on changes in trade laws, tariffs, and other trade regulations, on the availability of programs to assist Canadian companies to export, and so on. What small or medium-sized company has the resources to seek out that information and keep it up to date?

Much of that information is available – through published sources, the trade commissioners, and Ottawa-based trade officers in the Department of External Affairs – but it is collected and maintained in a haphazard way and, perhaps more important, it seldom gets out to the smaller companies, firms that really need it. The larger ones have learned how to obtain the information. They keep in constant touch with Ottawa, with Canadian posts abroad, and with various trade associations. They can afford to maintain libraries and research departments to scan publications and journals. They have representatives who travel to the markets. But the small and medium-sized companies and even some fairly large ones just can't afford to do all that.

Most exporters, therefore, require a well-established information-collection network and, equally important, a delivery system that really works. Here I think there is a significant role for private-sector organizations and for the provinces. My general impression is that most of the provinces are not only closer physically to companies but also have fairly good delivery systems throughout their jurisdictions.

Private-sector organizations also already have delivery systems. A number of trade councils have developed good information programs that include seminars, publications, and research papers, among other things. But they are generally supported by larger companies that are fairly well established in the markets the councils serve. Surely these organizations could play a more general role. Perhaps it might involve government's turning over certain activities to these bodies or contracting out programs to enable them to penetrate deeper into the business community.

Similarly, the large horizontal organizations, such as the Canadian Chamber of Commerce, the Canadian Manufacturers' Association, and the Canadian Export Association, could play a positive role in channelling information to Canadian companies. I have always considered it unfortunate that the well-established network of community chambers of commerce and boards of trade is not utilized to a greater degree. I frequently wonder whether it would not be much more effective and much less costly to the federal budget if private-sector groups such as these, along with the provincial governments, were invited to channel information to Canadian business and perhaps even to carry out certain federal programs for a fee.

As an aside, I might suggest that, somewhere in this country, we need to put in place a data base on products and services offered by Canadian companies, their areas of interest, and other information. Such a data base should be kept up to date and be easily accessed by various government departments, by the provinces and by business organizations. The Business Opportunities Sourcing System of the Department of Regional Industrial Expansion (DRIE) is a start, but it has never really been given the resources, the mandate, or the co-operation of other government departments and provinces necessary for success.

ON-SITE ASSISTANCE

The second requirement of Canadian exporters is on-site assistance. The tasks here involve:

- Seeking out opportunities.
- Providing much of the required information referred to earlier.
- Offering advice on how to approach particular markets.
- Advising on the selection of agents.
- Making initial contacts or appointments for exporters.
- Providing information on import rules and regulations.
- Fighting for fair treatment of Canadian companies.

To a large extent, these services are those already provided by Canadian trade commissioners abroad. But the role of and the need for on-site trade representatives vary dramatically from one region to another. In centrally planned economies, information, appointments, meetings, and other activities more often than not must be channelled through or organized by the Canadian trade commissioner. In Asia, the characteristics of business, the linguistic differences, and even the distance from Canada make the role of trade commissioner crucial. Much the same can be said about the Arab countries and, to some extent, Latin America. The United States is quite different. Business practices there are virtually the same as our own. There is no language barrier. The distances involved are relatively short. Information is as available as it is in Canada. In today's global village, Western Europe is also not a very different or distant marketplace.

Given these differences in the need for trade representatives in various regions of the world, I think we must carefully review the allocation of the scarce resources available to us. One has to question the rationale of maintaining large trade contingents in Western Europe and the United States while providing relatively meagre staffing in most of the Asian, Middle East, and Eastern European posts.

We also need to consider the quality of service Canadian companies are receiving from trade representatives abroad. At present, I think it is mixed and, regrettably, deteriorating. There are still some excellent people out there, but the overall service is suffering, in some cases because of work load and in others because of the government's organization, procedures, and approach. The slow, step-by-step absorption of trade representatives into the Department of External Affairs is taking its toll. We are seeing traditional foreign service procedures and attitudes prevailing to the detriment of the trade orientation that once existed. The crossposting of nontrade officers into trade posts may build well-rounded foreign service personnel, but is that what business needs? And while they are learning, who provides the service? The specialization that once existed is now being lost. We seem to be creating foreign service generalists instead of marketing specialists.

Moreover, recruitment policies are such that individuals entering the foreign service – and that now includes trade commissioners – are generally brought in at the most junior levels. I guess the theory is that foreign service officers must be moulded and trained within the system; any experience they might have gained outside it would be irrelevant. This may be the accepted method of creating diplomats (although I sometimes question even that premise), but I don't think it should apply to trade representatives. Frankly, I think trade representatives recruited from the ranks of the private sector might be much more effective. But if the only entry is at a junior level, how can we attract people from the private sector who have acquired a solid record of marketing experience?

I think it's also unfortunate that the cards seem to be stacked against applicants with an interest and experience in trade. I have been told that the examinations in the last recruitment round included questions on foreign policy, immigration, defence issues, and several other areas, but not one question on trade. Furthermore, the point system used rewards those with PhDs quite handsomely compared to those with lesser degrees. How many export marketers do you know in either government or business who have a PhD?

The services of trade representatives abroad are extremely beneficial to companies, but we have to make the best use of the resources available and ensure that the individuals who fill those positions are properly qualified and motivated.

Perhaps it is time for us to reassess the basic structure of our trade-promotion and trade-support services, particularly as they relate to the operation of our trade offices abroad and our Canada-based information services. Are these services best provided by governments? Or should we be considering the establishment of trade commissioners and a trade-information service outside the Department of External Affairs or even outside government? Why not look at the examples of West Germany, Austria, Hong Kong, Japan, Korea, and many others whose trade commissioner service is operated by the private sector supported by fees assessed on all businesses, on just exporters, or on both exporters and importers? This suggestion is not meant as a rejection of government or an indication of general dissatisfaction with trade officials. It is proposed as the next stage in the way trade services are provided to Canadian companies. Let's at least investigate the feasibility, along with the advantages and disadvantages, of such a system. As a first step, we should set up a small task force made up of private-sector and government representatives who could approach this issue with an open mind. They should investigate the practices of other countries and, if they believe changes to the current system are advisable, recommend a future course of action.

While I'm on the issue of representation abroad, I must question the need for the numerous provincial offices that have sprung up outside our borders. I tend to believe they duplicate the activities that are currently carried out by the federal government or that might be carried out by a restructured trade-commissioner service. I think they represent wasteful duplication of effort and resources and tend to be extremely confusing to the business people of the countries in which they are located. That is particularly the case where provincial representatives are located in facilities completely separate from those of the Canadian embassy or high commission.

IMAGE-BUILDING

Let me turn now to a less direct but still important government role in support of exports. It strikes me that government, in co-operation with business, must be active in creating a positive image of Canada and Canadian capabilities.

Here I am not referring to the image of Canada the peacekeeper or Canada, everyone's friend at the United Nations, or Canada, a middle power that has no military aspirations. These impressions of Canada may create an initial receptiveness in certain countries. But when a developing country is considering a large hydroelectric project or major upgrading to its telecommunications system, those images aren't going to do much to make it look to Canada as a logical supplier. What is required is recognition abroad of Canadian industrial and service capabilities.

Overcoming the image of Canada as a giant quarry and granary is a task that requires the combined efforts of both government and business. We must intensify our efforts to create an image of an industrially advanced country with technology in many sectors that is equal to that possessed by any so-called world leader.

Unfortunately, too few people in this country understand the relationship between the image of Canada and its capabilities and the image of a particular Canadian company. My criticism is directed at business as much as or more than it is at government. Too many companies believe that if they have technology and skills matching those of their competition from the United Kingdom, West Germany, Sweden, and the United States, they'll be considered on an equal level. Unfortunately, if the customer sees the United Kingdom, Sweden, and the United States as technologically advanced industrial nations and Canada as a basically agricultural and resource-rich country, the first task of the Canadian company is to convince the customer it really is in the same league. That task is time-consuming and expensive, but only after it is accomplished will the Canadian company even be considered. Then, it must get down to the business of offering a tender that is competitive in terms of price, quality, delivery, and all the other elements that go into a successful bid.

Canadian business people are not alone in failing to recognize the importance of underlining Canada's industrial and service capabilities. From my observations, many people in government don't recognize it either. Certainly image-creating seems to be well down the list of priorities. What we need in this regard are some well-prepared promotional material, the assumption of a more activist role by the Canadian private sector and by our trade representatives and diplomatic personnel abroad, and some carefully planned and organized missions whose primary objective is image-building. Our current missions tend to be organized to help individual companies to clinch contracts or at least to make initial contacts. (Some people might ascribe less noble objectives to many of our government-organized missions.) Although those are fine objectives and should be the prime ones for most missions, there is a place for special missions designed primarily to create a positive image and to raise the consciousness of the host country regarding Canadian capabilities.

This type of program is not one that could be carried out by governments alone. What is your normal reaction to government officials from a foreign country when they talk about the great achievements made by its companies? Probably you find such statements less than convincing. But most business people react somewhat more positively when the same messages are delivered by foreign business people themselves, by people who can speak authoritatively about what their own companies have accomplished. That's what we must do overseas. A number of experienced trade commissioners have frequently told me, 'We can talk all day about Canadian capabilities, but unless the people in authority here can meet with and talk to Canadian business people themselves, we can't really convince them.'

Convincing Canadian business people of the need to invest time and money in this type of image-building is not easy. The reaction is generally one of 'if I can't make a sale, why do it?' That's an unfortunate attitude. We may have many business people who are perceptive and farsighted when considering their own corporate strategies. But that farsightedness does not seem to extend to the international arena and the fact that, like it or not, every Canadian company is marked by the image of Canada.

FINANCIAL ASSISTANCE

To this point, I've addressed mainly the issue of assistance as it relates to information, on-site services, and image. However, as much as we might wish, in this era of restraint and deficit reduction, to avoid a discussion of financial assistance, I don't think we can ignore the reality of what our competitors in other countries have available to them. On the other hand, let's not get carried away with glorious assistance schemes that might achieve only marginal objectives or that might help uncompetitive companies export when they wouldn't be able to do so without the program. Frankly, we don't have the financial resources to develop assistance programs to meet everyone's objectives or to achieve only marginal benefits.

We do, however, have to compete in that world out there, and if most of our major competitors are receiving tax incentives, market-development assistance, or subsidized export financing, we can't just shake our heads, decry their actions, and let Canadian companies fare as best they can. We must at least try, given our limited resources, to minimize some of the artificial advantages that others are given. Our approach might be to match what others are doing. Or we might seek new methods of supporting our companies, methods that are quite different from those of other countries, but that have a similar effect, one hopes at less cost.

In my view, the preferred avenue of assisting Canadian exporters is through the tax system rather than through specific grants. Tax incentives provide businesses with greater latitude to plan their activities in the manner that will result in the maximum corporate benefit. Grant systems frequently cause companies to deviate from the paths they would otherwise take, in order to qualify for the grants. In the process, the effectiveness of the public expenditure is reduced significantly. Grants also tend to be awarded through a decision-making process that places power in the hands of bureaucrats. Such an approach is a comfortable one for people who believe in a concept of picking winners and losers and who believe that government decisions (or discretionary decisions by public servants) are better than decisions made by those who operate the companies themselves. However, I tend to believe that decision-making should be left in the hands of those who deal with market realities every day and who can generally react faster to changing conditions than do people who are somewhat removed from the market.

Having praised tax incentives, I must add, however, that one has to be very cautious about their nature and cost. If not carefully thought out and implemented, they can become a heavy drain on the public purse.

I think we should investigate four types of financial programs:

- General export tax incentives matching those available to our competitors.
- Market development assistance.
- Programs geared to achieving both export and other objectives.
- Export financing.

General export tax incentives

First, let's look at general export tax incentives. The reality of the US Domestic International Sales Corporation (DISC) program (now wrapped up in new clothes and with a new name) and similar tax incentives in other countries cannot be ignored. We must ask ourselves the central question: to what extent do these tax incentives in other countries create unfair advantages that Canadian companies must overcome? The ready answer is, if foreign firms have a tax incentive, their products and services can be offered that much cheaper than ours. But that statement is a bit too simplistic because it ignores the impact of the overall level of taxes and of all other taxes that our competitors may face.

First we must determine whether our companies do indeed face unfair competition as a result of the tax incentives others are given. Therefore, we are awaiting the results of a study the Department of Finance has commissioned on this subject. If it demonstrates that Canadian companies are at a disadvantage, we should take steps to structure a program that will reduce or eliminate that disadvantage. The challenge is to do so in such a way that the *net* impact on the public purse will be kept down (recognizing the tax revenue that increased exports would provide) and that we stay within the general GATT guidelines that govern this area of activity.

Market-development assistance

The second type of assistance relates to market development. The major program of this type currently available in Canada is the Program for Export Market Development (PEMD), which is a grant program designed primarily to offset the travel costs involved in developing new markets, although it can be used to cover various other costs.

Companies have generally given the PEMD high marks. It fills a definite need, particularly for small and medium-sized companies, and it is administered, by and large, in a responsive manner. Nevertheless, the PEMD is not without its weaknesses. It is, after all, a grant program. That means decision-making by officials, forms to complete for each trip or activity, and delays despite the generally responsive way in which it is administered. It is also used quite extensively by a few companies that know the system inside and out. Smaller companies have neither the contacts nor the resources to investigate every possible way of utilizing the program. Here again, many firms get some benefit, and a few get a great deal of benefit.

The program is not only time-consuming for companies; it is time-consuming for federal officials as well. Each PEMD application is first submitted to the regional office of the DRIE. Then it is forwarded to the appropriate regional branch at External Affairs, where it is reviewed and sent for comment to the Canadian trade commissioner in the foreign post concerned. Finally, it is processed by the PEMD officials.

Although the PEMD has been useful and beneficial, it could probably be even more effective if it were a tax-based program. Perhaps it could be structured so that a company could list its allowable expenses on its tax return and receive the appropriate benefit at that time. The size of the incentive could be limited by applying certain criteria – such as allowing only a percentage of export sales or excluding certain regions of the world – in order to minimize the impact on the budget.

Incentive programs with multiple objectives

Third, we could look at incentives that can achieve several objectives. The type of incentive program to which I am referring is one that would create stronger, more competitive companies but might also promote exports. I already referred to such a duality of purpose when I suggested a possible link between R&D incentives and exports. Perhaps supplementary R&D incentives could be given to companies that achieve certain increases in their export sales over a base period. Although the primary objective of such a program would be to increase R&D activity, it would also promote efforts to export.

Export financing

The fourth and perhaps most discussed type of financial program for exporters is export financing, generally associated in Canada with the Export Development Corporation (EDC).

It bears noting, at the outset, that approximately 90 per cent of Canadian exports are financed by private sources with essentially no government involvement. Most export financing is short term and provided by the exporters themselves or the private banking system. Almost all our exports to the United States (setting aside the much-publicized New York subway contract) are financed by private sources. The EDC is involved in only about 5 per cent of export financing and provides direct support to only 1 per cent. It's important to bear this in mind in order to keep the whole matter in perspective.

Further, we are wise to remember that financing, even in cases in which government or EDC is involved, is not the only factor governing the success or failure of a particular bid for an export order. Neither are price and quality, though essential preconditions, sufficient in themselves. As the *Export Financing* consultation paper (Canada 1985, 1) points out, ability to deliver, dependability and reputation of the firm, knowledge of the market, willingness to provide support, availability of service and spare parts, and ability to transfer technology are equally important factors in making a sale.

The financing package does become important when it involves exports to developing countries and to Eastern Europe, particularly for relatively large, and risky projects that require long-term credit arrangements. If price, quality, and other factors are relatively comparable among competitors, the financing package can frequently make the difference.

Frankly, if we are going to be in the game, we have to recognize the reality of all factors affecting exports. In some cases, doing so may mean subsidized export financing. Given the limited size of our treasury, our challenge is to make the most effective and efficient use of available resources. Because resources are limited, this is one area in which I don't think we can use the tax system to solve the problem.

No one in Canada can be pleased with the direction officially supported export credits have taken in the world. Notwithstanding the existence of international agreements on minimum interest rates and maximum maturities for export financing, many countries either ignore these accords or find ingenious ways of circumventing them in order to reduce the overall cost of financing. We should all support the federal government's efforts to achieve some degree of realism and effective co-operation, particularly among the developed countries on this issue.

We must also, however, address the question of what we do in the interim. Clearly, we must weigh the benefits of providing competitive export financing against the economic and financial risks and costs. We simply could not survive an export credit war and, therefore, should not take any excessively aggressive steps that might contribute to one. As the government's *Export Financing* states, 'The primary objective of government export financing programs should be to put Canadian exporters on an equal footing with foreign competitors' (Canada 1985, 3), not to lead the way.

Financing exports to developing countries

There are several reasons we must particuarly seek to be competitive in export financing in the developing world. First, we must seek to increase our presence in the markets of the developing countries, which are becoming, as a group, a major player in international trade.

Second, Canada does not have military or historical relationships with developing countries. Since Canada is not a world military power, it cannot use military support for particular governments as a means to achieve economic ends. Furthermore, we do not have old colonial ties, such as the British and French use with great effect in commercial dealings with their former colonies. Although much can be said about the animosity of newly independent nations towards their former masters, there is little doubt that the business relationships established under colonial rule are aggressively maintained in many areas.

Third, many of the goods and services in which Canada is particularly competitive relate to infrastructure projects. The developing countries are the major focus of infrastructure projects today. In these markets and for these projects, competitive export financing is a key. Furthermore, there is a fair amount of merit in the theory that the supplier of the basic infrastructure will receive significant additional business as the infrastructure expands.

Still, we cannot afford to subsidize export financing for every project. Nor can we afford to be leaders in this area. Instead we must restrict our involvement to matching what our competitors provide. Perhaps most important, we can't afford to 'buy' projects or to provide assistance in order to prop up bids that would otherwise be uncompetitive. The criteria to be considered in responding to requests for concessional financing might include:

- The capability of the Canadian company to be competitive in terms of price and quality, apart from the financing package.
- The benefits that would accrue to the Canadian economy.
- The possibility of long-term recurring business for Canada.

Since concessional financing often involves developing countries, it stands to reason that the Canadian International Development Agency will be involved or, at least, affected by any programs of concessional financing. Indeed, the funds required to put together competitive financing packages could logically come from CIDA.

There has been much public debate about the insertion of commercial objectives into CIDA's current developmental objective. I do not believe there is any inherent conflict between the pursuit of developmentally sound projects in Third World countries and the tying of available funds to projects carried out by Canadian companies. If Canadians can meet the competitive criteria for supplying a project and that project serves the needs of the recipient country, why should Canadian aid funds not be used to finance Canadian goods and services rather than those of another country?

I support, therefore, the development of an aid/trade fund mechansim. The source of financing for the fund was to be increases in Official Development Assistance (ODA). Since ODA increases will now be somewhat smaller than originally conceived, the aid/trade fund would be limited at the beginning, but it might be enlarged by diverting some resources from CIDA's bilateral program, which, because of its long-term planning process, lacks the flexibility to respond to requests for concessional financing.

Perhaps the need to balance developmental and commercial objectives in the provision of concessional financing could best be accomplished if the proposed aid/trade fund were housed in the Business Cooperation Branch of CIDA. That branch, which includes the Industrial Cooperation Program, has developed a close working relationship with the private sector and has demonstrated the agency's capacity to operate with dual objectives. In addition, a program administered by the Business Cooperation Branch might logically include other mechanisms to support Canadian exports, such as a broad approach to the financing of feasibility studies for projects in developing countries to ensure that Canadian capabilities and products are not overlooked in the specifications for the project itself.

The private sector and export financing

There is, of course, another aspect of export financing that should be addressed in addition to concessional financing. It includes the whole structure of the provision of export financing services, concessional or commercial, and the role of the private sector. When the Export Development Corporation and its predecessor, the Export Credits Insurance Corporation, were established, I think it is fair to say private Canadian financial institutions were not in a position to provide medium- and long-term financing of exports, nor were they generally interested in doing so. That situation has changed quite dramatically in the past decade, particularly in the last five years. Canadian banks have developed quite sizeable international operations and expertise. The entry of foreign banks into Canada has also sparked a heightened interest in international banking and trade finance. In addition, the asset bases of most banks are such that they are able to finance major exports without fear. Furthermore, there is a very strong interest among Canadian banks, including the Schedule B banks, in becoming involved in medium- and long-term export financing.

Given these changed circumstances, is there still a need for a government organization engaged in the full range of long-term and some medium-term export financing activities? The *Export Financing* consultation paper (Canada 1985, 12-15) presents three options to increase the involvement of banks and other financial institutions in medium- and long-term export financing:

- Defined market shares for private financial institutions and the EDC.
- Competition between them.
- Taking the EDC out of export financing.

The debate generated by the publication of these suggestions has not been very public, but it has been intense. On the one side is, of course, the EDC, which likes things just as they are. It is supported by some large exporters who know the system, the people within it, and the politics of securing favourable export financing and would rather it not be tampered with. Furthermore, they may also be of the view that the fewer who know the intricacies of the system, the less competition there will be for the limited financing, especially concessional financing, Canada has available.

On the other side are the private financial institutions, particularly the banks, represented by the Canadian Bankers' Association. They advocate transferring all export financing to the private sector, with government providing some form of interest make-up or fee to meet the costs incurred by private institutions in providing the service, particularly if concessional financing is involved. The banks point to their vast network of branches across the country as the ideal mechanism through which export financing could be made more accessible to small and medium-sized companies. They also point to their international network and to their ability to promote Canadian exports and to monitor financing arrangements.

Somewhere in the middle are the vast majority of exporters and potential exporters, who don't particularly like the current system but are not sure of the alternatives or who just don't understand and have never used EDC. I suspect the federal government, particularly the Department of Finance, is also in the middle ground. It would like to involve the private sector to a greater extent, but it is not quite sure how to structure that involvement in order to ensure that the cost to exporters is not increased and that the cost to the government will be kept in check.

The debate underway between the two ends of the spectrum has prompted the EDC to take the remarkable step of issuing a paper strongly refuting the proposals included in a working draft of a submission by the Canadian Bankers' Association and virtually rejecting any change to the status quo.

I lean towards the side of the private financial institutions. I do not believe that government institutions should be involved in activities that can be carried out by the private sector. Times have changed, and institutions must change as well. What is important is to ensure that export financing is made available to the broadest possible range of Canadian companies in an efficient and cost-effective manner. A number of questions and concerns exist regarding the cost to taxpayers and to exporters of a change in the system. The estimates presented by both camps are so different that I think we need an independent assessment before any final decision is made.

Many of the same observations apply to the question of a greater role for the private sector in the provision of export insurance. Canadian insurance brokers have now probably reached the position of being able to provide many of the insurance and guarantee programs currently offered by the EDC.

Trading houses

Another subject that has generated much discussion throughout the past five years is the need for stronger trading houses in Canada. Quite properly, the former federal government quashed the concept of a national trading corporation. A recent study on the subject (Canada 1984) has identified a number of steps that could be taken to strengthen existing trading houses and to encourage the creation of new ones.

Trading houses can perform a valuable role in promoting Canadian exports. For too long, there seems to have been an impression in this country that trading houses are a kind of second-best method of international marketing. This attitude does not reflect the experience of most major trading nations. Trading houses play a key role in Japan, West Germany, France, and other countries. In fact, strong trading houses could give a major boost to the export potential of many of Canada's small and medium-sized companies that simply do not have the resources or expertise to undertake an international marketing program.

Canadian trading houses do seem to have a shortcoming: because they are generally small, they lack financial resources. Here again, the banks could play a role by providing financing. They could take a more direct part as well. You don't have to scratch very far below the surface of major trading companies in Japan or Europe to find banks involved in the ownership. The United States has recently amended its laws to allow banks to invest in trading companies. These examples suggest that Canada should amend the Bank Act to allow banks to invest in or establish trading companies. Given the branch system in Canada and the international networks of Canadian banks, there would seem to be a great deal of merit in allowing them to engage in direct exporting.

The Canadian Commercial Corporation

One cannot discuss trading companies or the government's role in exporting without making at least passing reference to the Canadian Commercial Corporation. In recent years, it has attempted to branch out from its primary role under the Canada/US Defence Production Sharing Agreement to become a trading company or a prime contractor in capital projects. Its efforts have not met with success in these other areas. Frankly, there does not seem to be a need for the CCC to become an activist trade organization. Instead, its mandate should be reduced to the basic role required under the Canada/US Defence Production Sharing Agreement and, beyond that, to responding to demands for government-to-government contracting as required by foreign governments.

DIRECT FOREIGN INVESTMENT

Discussions of export promotion and support often reflect a tendency to disregard the relationship between trade and investment. I don't think there ever was a time when trade and investment could be treated as two distinct entities, but if there was, it has long since passed. Canadian investment abroad can facilitate and spur the expansion of foreign trade.

If Canadian companies are to be competitive internationally, they must consider the necessity of supplementing their Canadian-based operations with facilities abroad wherever these will enable them to provide goods that are competitively priced and of high quality. I don't wish to overstate the premise or to suggest it applies in all or even the majority of cases, but investments and other forms of international co-operation, particularly in developing countries, could in many cases become an integral part of future business operations with benefits accruing to both Canada and the host country.

However, the reaction one gets in Ottawa to the suggestion that the government should be encouraging Canadian investment abroad is puzzling. With the exception of the Industrial Cooperation Program of CIDA and the EDC investment-insurance program, there is virtually nothing to encourage Canadians to invest abroad. Many officials agree privately that Canada on the whole benefits from outward investment, just as it benefits from inward investment, but there is a great reluctance to express these sentiments publicly. The old bugbear that investment abroad means exporting jobs still seems to hold sway in many circles in Ottawa – not in the sense that it is believed, but in the sense that people are afraid to challenge the conventional wisdom publicly. This fear is based upon an outdated theory that for every investment a Canadian company makes abroad, there is one less investment in Canada. That is simply not so. Internationally oriented firms increase their domestic investments at a faster rate than companies that stick close to home.

It is time for Canadians to realize that their economy has grown up. Instead of being frowned upon, Canadian investment abroad should be actively encouraged and supported by the Canadian government here in Canada and in international institutions.

SUMMARY

To summarize, I believe that government can play a positive role in promoting exports and assisting exporters. A major part of that role is to provide the proper environment for Canadian companies to compete effectively in international markets by:

– Ensuring that Canada's trade policies promote international competitiveness among Canadian companies and cultivate access to foreign markets.
– Implementing domestic policies that similarly promote increased productivity and increased international competitiveness.

Beyond this broad environment-setting role, governments can support Canadian exporters, directly, in co-operation with the private sector, or through private-sector institutions by:

- Providing market and other information to Canadian companies.
- Ensuring adequate on-site support for exporters.
- Raising the image of Canada as an advanced industrial economy.
- Making available tax and other assistance to promote exports or to enable Canadian companies to compete on a 'level playing field' with others.
- Providing competitive export financing.

Governments can also support exports by encouraging the growth of Canadian trading houses and Canadian investment abroad.

Canada has become a mature country. As a consequence, it is quite possible and, in many instances, desirable for governments to look to the private sector to play a greater role in the development and promotion of Canadian exports. The private sector should welcome and grasp that opportunity. But whatever the structure of our trade programs in the future, governments and the private sector will have to work together in partnership. I cannot think of one major trading nation in the world that does not exhibit that close, co-operative approach. Canada cannot afford to be different.

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Government export subsidies

André Raynauld

Government assistance to exports has become an increasingly important component of trade policy in most countries, developed as well as developing. The statement is certainly true of Canada. Leaving aside tax policy and other export promotion expenditures, Canadian governments' financing of exports was about $4 billion dollars in 1983, comprising loan disbursements of $1.8 billion by the Canadian Wheat Board, $1 billion by the Export Development Corporation, $1 billion by the Canadian International Development Agency, and some $40 million by provincial Crown corporations. When that is compared with the $3 billion that customs revenue totalled in 1983, direct export assistance can be seen to exceed tariff collections by a significant margin.

This is to say that a new protectionism is taking over the old protectionism to the extent that government financing artificially reduces the supply price of exports in favour of domestic production. The final objective is the same as that of tariff protection but there are several differences between the two approaches to trade policy. With government export financing, the actual degree of protection is not, of course, measured by the amount of financial commitment but by the associated explicit or implicit subsidy. Subsidization, in turn, is a cost for society as a whole. Thus the issue is whether there are private and social benefits that can justify the expenditure.

Professor Raynauld teaches in the Département de sciences économiques and is a member of the Centre de recherche et développement en économique, Université de Montréal.

Official export credits will doubtless loom very large in future international trade negotiations. Indeed, they are already important in the negotiations that have been going on for years under the aegis of the Organization for Economic Co-operation and Development (OECD). The current understanding provides member countries with guidelines for export financing: a minimum cash payment of 15 per cent, maximum loan maturities, and minimum interest rates. This consensus has resulted in significant progress in the last few years in preventing excessive subsidization by means of automatic, semiannual adjustments of the minimum interest rates to changes in the market situation. These minimum rates in July 1984 were set at 10.7 per cent for poor countries, 11.9 per cent for middle-income countries, and 13.6 per cent for high-income countries. A recent international study, shown to me in confidence, indicates that as a proportion of total financing, subsidies increased substantially between 1979 and 1982 but declined in 1983. It was expected that they would decline still further in 1984.

In spite of this recent progress within OECD, export financing is still a major issue because important subsidies are still given, new players join the game, large sectors such as agricultural products are not covered in any international agreement, and the widespread practice of using mixed or parallel credits that involve both commercial lending and aid is extremely difficult to monitor.

THE COST OF EXPORT FINANCING

In Canada, export insurance and financing of manufactured products are provided mainly through the Export Development Corporation, set up by the federal government in 1944 and reorganized in 1969. I have assessed EDC's programs in export financing (Raynauld 1979; 1985; Raynauld, Dufour, and Racette 1983) and updated my results for this presentation.

In such studies, the key step on the cost side is determining the amount of subsidy involved in granting credit to foreign importers. The conceptual definition of subsidy here is clear enough: it is simply the difference between the rate of interest determined in the competitive market and the effective rate charged the borrower.

The situation is entirely different, however, when it comes to empirical estimates: they are sold by the dozen. Two sets of measures are used here. One reflects the financial cost of capital, taken to mean the average rate of interest on the federal public debt outstanding. The assumption is that the EDC is using government funds or borrows on the market at the same rate as the federal government. However, the EDC does not necessarily lend at cost or even at profit. Because of lack of information on actual loan rates on transactions, I have calculated an average rate of return on loans outstanding and interpret the difference between the borrowing and lending rates as the rate of subsidy.

Except for the fact that the subsidy is calculated here on the basis of stocks rather than flows, this financial cost-of-capital approach has become fairly common in the literature and official estimates abroad. It is readily apparent that even if the EDC were lending at cost, no private borrower and few foreign governments in less developed countries would be able to get its terms on the market. The subsidy defined in this way is, therefore, severely underestimated.

An alternative approach is to derive estimates from the social opportunity cost of capital in Canada, as established in several studies by Glenn Jenkins (1980; 1981). If the real cost of capital is set at 10 per cent, the difference between it and the real net return on the EDC's loans produces an estimate of the subsidy – or what I prefer to call the rate of social loss for Canadian society as a whole. Here again, the calculations are made on loans outstanding as of a certain date rather than on annual flows.

The results of these two procedures are given in Tables 1 and 2. On average during the 1970s, the EDC subsidy as measured by the cost of the public debt was modest. It amounted to less than 1 per cent and involved no more than some $11 million a year. By contrast, it reached 5.8 per cent in 1983, as the average net return on lending did not follow the considerable increase in the interest cost of the public debt. The value of the subsidy in 1983 alone totalled $285 million.

The estimates based on the social opportunity cost of capital show strikingly different results. Throughout the 1970s, the real rate of return on EDC loans was -1.5 per cent, so the social loss incurred was 11.5 per cent if the cost of capital is set at 10 per cent, 8.5 per cent if it is set at 7 per cent. Given the value of loans outstanding, the social loss was in excess of $100 million a year. By 1983, the rate of inflation had receded sufficiently to produce a positive real rate of return on loans. The rate of social loss was thus significantly lower, at 6.5 per cent or 3.5 per cent depending on the assumed cost of capital. How-

TABLE 1
Financial subsidies on export financing by EDC

	1970-80	1980	1983
1 Borrowing cost	7.6%	9.9%	14.7%
2 Gross rate of return on loans outstanding	7.2	8.6	9.5
3 Net rate of return on loans outstanding	6.9	8.3	8.9
4 Rate of subsidy (line 1 – line 3)	0.7	1.6	5.8
5 Annual subsidy (millions of current dollars)	$11.3	$46.5	$285.0

NOTES:
Line 1 = Average interest rate on federal public debt outstanding.
Line 2 = Interest and fees earned on loans outstanding, excluding provisions for losses.
Line 3 = Same as (2) less administrative expenses.
Line 5 = (4) multiplied by loans outstanding.
SOURCE: Personal calculations from EDC annual reports (corporate account).

TABLE 2
Social opportunity cost of export financing by EDC

	1970-80	1980	1983
1 Net nominal rate of return	6.9%	8.3%	8.9%
2 Net real rate of return of loans outstanding	–1.5	–2.3	3.5
3 Rate of social loss with opportunity cost of capital set at:			
10% opportunity cost	11.5	12.3	6.5
7% opportunity cost	8.5	9.3	3.5
4 Social loss (millions of current dollars)			
10% opportunity cost	$138.0	$361.0	$319.0
7% opportunity cost	102.0	273.0	172.0

NOTES:
Line 2 = (1) adjusted for the GNE deflator.
See Table 1 for other definitions.
SOURCE: See Table 1.

ever, because the EDC had some $5 billion invested by then, the absolute amount of loss for the year still exceeded $300 million assuming a cost of capital of 10 per cent.

Since the loans granted last much longer than a year, these estimates are only part of the story. If there is a subsidy involved, it is paid year after year on net balances until the loan is fully reimbursed. The standard procedure for taking the credit periods into account is to calculate the present value of the cumulative subsidy or loss discounted by the relevant capital cost. Using loans outstanding, as I do, it is necessary to have an estimate of the effective average term of the portfolio. For several reasons, I believe that term is about seven years, but I have also made calculations on a more conservative assumption of five years. The results are given in Table 3. The present value of the total financial subsidy as of 31 December 1983 was $1.4 billion on a seven-year basis; this amount represented 28 per cent of the loans outstanding. Using the alternative basis of social loss, the present value reached 35 per cent of the loans outstanding.

The easiest way to interpret these figures is to ask: What would have been the financial or social loss if the EDC had discontinued its activities at the end of 1983? As shown in the previous paragraph, the answer is 28 per cent.

These figures may appear very high, but they are not. I have found similar and even higher estimates applying to other countries, and the present procedures did not include a cost premium for country risk.

POTENTIAL BENEFITS FROM EXPORT FINANCING

So much for the extent of subsidization associated with export financing by the EDC. An overall assessment of the program further requires an examination of the potential private and social benefits that may compensate the burden of the subsidy. Benefits do not, however, lend themselves to accurate quantitative estimation as does the cost of capital. The summary that follows is therefore somewhat more speculative than the previous section.

To credit a benefit to a government program, it is necessary to show that the program produces something in addition to what the market would have produced if left to itself. Otherwise the program amounts to a transfer from the private sector to the public sector with no net gain overall.

General theory indicates that the efficiency of the market system can be improved by government intervention if and when there are market failures resulting from insufficient competition, when there are externalities, or when the intervention can reduce distortions in

TABLE 3
Present value of financial subsidy and social loss from EDC loans, 1980 and 1983
($ values in millions)

	1980	1983
Financial subsidy		
Subsidy for the year	$46.5	$285.0
Subsidy at maturity		
5-year average, outstanding loans	194.2	1,104.0
7-year average, outstanding loans	250.0	1,372.0
Rate of subsidy at maturity		
5-year average, outstanding loans	6.6%	22.5%
7-year average, outstanding loans	8.5	28.0
Social loss[a]		
Loss for the year	$361.0	$319.0
Loss at maturity		
5-year average, outstanding loans	1,505.0	1,330.0
7-year average, outstanding loans	1,933.0	1,780.0
Rate of loss at maturity		
5-year avearge, outstanding loans	51.4%	27.1%
7-year average, outstanding loans	65.9	34.8

[a] Social opportunity cost of capital set at 10 per cent.
SOURCE: See Table 1.

the economy. Governments may also adopt policies for redistribution, and this is generally considered legitimate. Whether the rationale is efficiency or redistribution, however, the policies themselves must be efficient in the sense of producing the benefits at the least possible cost.

With these general considerations in mind, let us review the potential sources of benefits.

The incidence of the subsidy

Subsidies and social losses, as previously estimated, are a true welfare cost to Canada only if they are transferred in total to the borrowing country. Such a transfer need not occur: some of the subsidy may be captured by the exporters in the form of higher prices. In the extreme case of perfectly inelastic supply, the excess demand created by the subsidy bids up the price and the total subsidy goes to the exporters. For the country as a whole, there is then no net welfare loss and the subsidy is a transfer from the taxpayers to the exporters. But this result involves no increase in exports either. The impact is analogous to that of tariff protection, which implies a transfer of resource from consumers to domestic producers.

Using available estimates of supply and demand elasticities, Fleisig and Hill (1984) take the view that between 50 per cent and 100 per cent of the subsidy is transferred to the borrowing countries; my best guess is that 75 per cent of the cost is borne by Canada as a whole. In other words, 25 per cent is recouped by exporters and 75 per cent goes abroad.

To understand this mechanism correctly, it is useful to look at an example. Assume that a unit of a given product is sold internationally at $100, while the marginal cost of producing it in Canada is $110. Because the government's subsidy is $10, the exporter gets the order, and the subsidy clearly goes to the borrower. Canadians are selling below cost, and the taxpayer is paying the difference. Now suppose that the true cost of production is only $100, but the producer charges $110 in anticipation of the subsidy (or for some other reason). In this case, the order would have been accepted anyhow, and the subsidy from the taxpayers ends up as excess profit to the exporter. The country as a whole does not lose in the process, but redistribution takes place.

This situation is often presented in more general terms as the issue of 'additionality' (Baron 1983) or 'incrementality' (EDC 1982). How can one ascertain that subsidized export orders would not have been obtained without the subsidy and at no cost to society? David Baron (1983) recently reviewed attempts made in the United States to answer this critical question. Although he finds the indicators used imaginative and potentially helpful, his overall judgement is the evidence is still too subjective and arbitrary to meet the problem. (Whatever the merit of the procedure, the results for the United States confirm that some 75 per cent of the subsidy is transferred to the borrowing countries [Baron 1983, 191 ff].)

In its evaluation report of August 1982, the EDC attempts to estimate the gross and net benefits of its lending activity in 1980 and

1981. Its general procedure appears to have been as follows. First, a certain proportion of the loans is determined to be the net additional exports resulting from the EDC financing. Then the benefits are identified as the private return to capital by the exporter, the taxes paid, and a premium for foreign exchange earned, plus an allowance for the difference between wages paid and the social opportunity cost of labour. Neither detailed estimates nor the link between net additional exports and benefits are presented. On the cost side of the equation, both the financial and social concepts are discussed, but it is not clear which of the two are actually used in the final estimates. A country risk premium is added to the cost.

Difficult to assess as this method is, it is worth noting that it produced net benefits of 3.8 per cent and 5.2 per cent of the loans granted in 1980 and 1981 respectively.

Market failures?

It is close to impossible to provide hard evidence on market failures. However, one may turn the question around and concentrate on the services provided by the EDC that are not provided by the private sector.

Until very recently, no private insurance company was willing to compete with the EDC to provide export coverage outside the United States. This is hard to understand since more than 80 per cent of EDC's insurance business involves relatively short-term, recurring transactions with experienced exporters – an activity profitable for the EDC at what appear to be internationally competitive rates. The only obstacle to private-sector involvement seems to be the EDC itself.

In the field of export financing, the EDC concentrates its activities on longer-term loans at fixed interest rates, a segment of the market that the banks appear to be unable to serve. However, this is not necessarily a market failure, to the extent that this service can be offered only through subsidies. And given the subsidies, the banks are obviously unable to compete with EDC. This particular feature of the government program, plus the fact that the banking industry in Canada is fairly competitive, leads to the conclusion that there is no market failure in export financing. (I must admit that I have been less certain on this point in the past than I am presently because the degree of subsidization was less pronounced then.)

Externalities

A second set of considerations relevant to the assessment of public policies and their potential benefits introduces the notion of externalities.

The main social benefits that are invoked in support of government export financing are job creation, trade diversification, and the improvement in the industrial structure.

Job creation is certainly the most popular argument in favour of anything that a government may wish to undertake. So it is with export financing. This issue must be addressed in a macroeconomic setting. Whether aggregate output is increased or not following a new export order and whether jobs are thus increased overall depend on the shape of the aggregate-supply curve. When the economy is in a deep recession and all resources are in excess supply, it is obvious that an extra order can be filled with no increase in wages or prices (although, even then, the rate of exchange may increase). The reverse situation – in which resources are already fully employed in the Keynesian sense – can lead to no extra output and hence no extra jobs. Thus, for government export financing to fulfil its promises, the economy must be in permanent depression; alternatively, the timing of the government programs must be adjusted – opened up or closed down – in anticipation of the next turning point. Short of these conditions, the claim of the EDC's annual reports that it creates some 150,000 jobs year after year, irrespective of the general state of the economy, has no validity.

To get valid estimates of any job creation resulting from export financing requires the use of general equilibrium models. The early simulations made in Canada, using the TIM and CANDIDE models, were not designed to determine whether total exports and output increased following the introduction of public export financing. In one case, exports were assumed to increase; in the other, the aggregate supply curve was horizontal by assumption. The only other relevant evidence in this area is estimates on crowding-out (O'Reilly, Paulin, and Smith 1983). This is fairly indirect evidence since the overall demand shock that serves as the initial step in the simulations has little to do with export financing. Nevertheless, it can be seen from several different models that there is some crowding-out. My own judgement is that, for all practical purposes, no more than half the initial expenditure can be claimed as producing net additional output and employment.

A second possible external benefit from export financing is trade diversification. In fact, the EDC does contribute to opening up new markets for manufactured goods. About 70 per cent of its credits go to countries other than the United States and European nations. However, market diversification is not an externality. A private producer wants to minimize risk and so seeks the most diversified investment portfolio, customers, or suppliers possible. Left to itself, the market should produce an optimal degree of diversification. To have the government assist in going further may simply create new distortions and increase the risks beyond good business practice.

Improvement in industrial structure is a third category of benefits that have been claimed for export financing. This is a true externality. But the EDC does not contribute to changing the structure for the better. Two criteria can be used to determine the issue: labour productivity and the before-tax rate of return on invested capital. The industries assisted by EDC have the same average level of labour productivity as total manufacturing, and they perform less well on the rate of return than does the manufacturing sector as a whole. One must conclude, therefore, that EDC programs do not improve the allocation of resources within manufacturing.

Correcting distortions

To reduce or compensate for distortions is generally viewed as a valid reason for government action as it may improve efficiency and welfare. It has been argued that export subsidies can be justified as compensation for import barriers, which tend to depress exports and artificially increase the rate of exchange. Jenkins and Kuo (1985) estimated recently that because of trade barriers, the social value of foreign exchange exceeds its market value by 6.5 per cent. This premium, they say, should be considered a benefit associated with export performance.

This contention is perfectly acceptable. But a much more efficient solution to the problem would be to eliminate the tariffs and other obstacles to trade that created the distortion in the first place. It is always amazing to see export promoters, inside or outside government, making fervent pleas for exports while saying nothing about – or worse, supporting – the whole network of trade barriers. Surely export subsidies are just one more distortion added to the others.

The situation is altogether different for the distortions that come from foreign governments' subsidies on exports. They raise questions of fairness as well as efficiency. If the foreign subsidies are deemed permanent, efficiency considerations would indicate we should not try to meet that competition, though compensation may be justified for the producers who have to do something else and face transition costs getting there. If, on the other hand, the foreign subsidies are temporary (which is much more likely), an ad hoc policy of countervailing subsidies may be in order. This is the response that the Canadian government adopted three years ago to deal with specific cases of unfair competition.

Redistribution

The last category of arguments in support of government export financing centres on redistribution. It is said that export financing has provided or should provide benefits by assisting small businesses to enter foreign markets and contributing to regional development in Canada.

There is no objection to reaping secondary benefits of this nature from a government program. However, it is totally inappropriate to consider either one of these desiderata proper objectives for export financing. When it comes to long-term projects in the more distant and difficult countries of the world, what are the grounds for favouring small business to the detriment of larger firms? There must be more efficient, direct ways of assisting small firms than to ask them to assume excessive risks. The same rule should apply to regional development. Export assistance can be only a tortuous way of promoting balanced regional development. Surely it would be easy to design alternatives that come closer to the target.

CONCLUSIONS

In summary, Canada has invested considerable amounts of funds in export financing. Between a quarter and a third of these funds represent a gross subsidy or social loss over the duration of the loans, three-quarters of which are transferred to foreign borrowers. The cost of the policy to Canadian society can be estimated to lie in the neighbourhood of $1 billion, taking the total EDC loans outstanding in 1983 as a basis for calculation (Table 3). Admittedly, the last three years are probably not representative of the future. The point is that government export financing appears to be an expensive policy.

Potential benefits could, in theory, outweigh the costs. In point of fact, however, there is no credible evidence that I am aware of that the expenditure is justified, except in some specific and infrequent cases in which foreign governments' subsidies make the difference between success and failure in winning a contract.

If international negotiations towards freer trade are resumed, Canada should be prepared to recognize the vital importance of exports so long as they are competitive and to hold fast to the full, clear knowledge that Canadian financial institutions in the private sector can provide most of the services needed to this end.

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Discussion

QUESTION: I'd like to hear more from the panelists on linked aid and trade.

ANDRE RAYNAULD (Université de Montréal): Nobody has ever been able to solve the problem of how to minimize the trade distortions of aid programs. I don't think any government can oppose another government that wants to give money away – that's the privilege of a government. But whether the money is given to help exporters or underdeveloped countries, it always distorts trade in some way.

The problem is made more complex by the practice of mixing aid and trade credits. That obscures the fact that governments are providing aid to what had been considered purely commercial operations. As I understand it, a 'mixed credit' in the Organisation for Economic Co-operation and Development now has to be at least 20 per cent pure aid. I don't know whether that percentage is sufficient, but the situation gives rise to all sorts of opposition by exporters. If an exporter thinks a potential order is to be a commercial transaction and then discovers a competitor got it because it was called aid instead of trade, you can understand that exporter's feeling that unfair competition is involved.

The other problem is that you never know for sure whether the competition is fair or not because you don't really know all the details of the components of price, quality, and the nature of the product. Take export financing. Mr. Seitz quite correctly said that it would be quite all right if all the other components of a transaction were really competitive, but how do you know they are?

The policy principle in these cases has been to try to meet the competition, but again that runs up against the problem of getting very good evidence. I think we should not follow all foreign examples all the time. We shouldn't adopt policies just to imitate what someone else is doing; we should adopt them because we see some benefits for our own country. Following that rule, if the competition is temporary, there's a good case for providing a compensating subsidy – because if the exporter loses an order, he may have to do something else with resultant adjustment and transition costs, and because fairness, as well as efficiency, is probably involved. But if the competition is permanent, I don't think we should meet it at all costs.

RODRIGUE TREMBLAY (Université de Montréal): This panel provides a good opportunity to raise questions about the relationship between trade liberalization and export subsidization. Since foreign tariffs are a tax on our exports, trade liberalization and subsidies to exports can be conceived as alternatives. Is trade liberalization a better approach than subsidies to increasing our exports?

Another related point is the extent to which sectoral export subsidies are an answer to the distortions created by sectoral trade liberalization. The program I have in mind is the Auto Pact. It was a boon to one industry and for one region, Ontario. To a certain extent, I suspect that the federal government's expansion of the Export Development Corporation to subsidize the exports of other industries, especially those of Quebec, was an answer to the distortions created by the sectoral liberalization of the Auto Pact.

ANDRE RAYNAULD: I don't believe that export subsidies are an alternative to liberalization. Even if an export subsidy tends to increase trade (as against a tariff, which reduces trade), it furthers domestic production. I come back to the elementary conviction that a subsidy means producing at a loss. What is the point of a country's producing at a loss? If there are noneconomic reasons for generating activity, we have available policy measures that would be much less discriminatory than export financing. An increase in government expenditures or a reduction in taxes would probably provide as much support for activity and that support would be widespread. Export financing favours certain industries and firms against others; you end up asking whether those are the right industries and firms. Liberalization is certainly a much more positive approach to competitiveness.

The issue of sectoral liberalization raises the whole question of whether you should introduce a distortion in one area to compensate for one you have introduced in another. In the first place, we know that this is very difficult to do. Second, if we think that sectoral

liberalization is producing some cost for other sectors, we would do better to try to get a comprehensive trade arrangement rather than to introduce further distortions into the economy.

Nontariff measures: perceptions and reality

M.G. Clark

Before the Tokyo Round of negotiations under the General Agreement on Tariffs and Trade, Canadian discussion of a free-trade area with the United States focused largely on tariffs (see, for example, Private Planning Association of Canada 1963; Economic Council of Canada 1975). Since then, however, the discussion has focused more on nontariff measures. This shift of emphasis reflects the fact that the Tokyo Round, combined with the six previous GATT rounds of negotiations as well as two negotiations among the United States, Canada, and other developed countries before the war, reduced industrial tariffs to levels that are probably lower than at any time since the 1870s.[1] By 1987, an estimated 80 per cent of Canada's exports of industrial products will enter the United States duty-free and another 16 per cent will pay duties of 5 per cent or less. US tariffs will provide substantial protection for only a few types of products industries[2] and no longer constrain most Canadian industries from obtaining economies of specialization and scale.

During the last year or so, I have reviewed much of the literature on a Canada/US free-trade agreement and noted a number of perceptions relating to nontariff measures that, in my view, do not reflect reality. It seems useful to comment on some of them here. In the light of these comments, I will also make a few observations on the federal government's discussion paper *How To Secure and Enhance Canadian*

Mr Clark is president of Melvin G. Clark & Associates Limited, Ottawa. The author regrets that circumstances made it impossible to provide full citations for some quoted material.

Access to Export Markets (Kelleher 1984), which is one of the working papers before this conference.

US USE OF NONTARIFF MEASURES

An important part of the case now being made for a free-trade area with the United States is that that country is making frequent use of nontariff measures to restrict imports from Canada. This perception has, for example, been articulated by the Business Council on National Issues:

> Non-tariff barriers have become relatively much more significant, and, with the recent recession, protectionism has shown an upsurge. With the great stake Canada has in the United States market, Canadian exporters are often the most vulnerable.

Beigie and Stewart make much the same point, stating that a 'key' feature of 'the historic Canadian sense of economic vulnerability' is 'the increasing resort to non-tariff measures by the United States federal and state governments [which] has created major barriers to Canadian exports'.

Certainly, US interests can petition Congress to increase protection against imports. Hundreds of bills providing more protection are tabled in Congress each year, but very few become law. Such bills have been tabled in substantial numbers for decades, so they are hardly a new phenomenon.

US interests can also petition the administration to increase protection against imports from noncommunist countries because of dumping, subsidies, unfair import practices, unfair foreign practices, or violation of US rights under trade agreements and safeguard action. Information relating to such petitions submitted during the six-year period of 1978 to 1983 was recently assembled. Of the 662 petitions submitted during those years, forty-four related to imports from Canada; only eight of these resulted in protective measures;[3] and on 1 January 1984, only four such measures were still applied. Although Canadian provincial and federal governments granted subsidies to producers totalling billions of dollars annually, there were only thirteen petitions requesting countervailing duties on imports from

Canada, and only one petition resulted in the levying of such duties (on optic-sensing systems).

Even when the administration does not increase protection, petitions fo. increased protection harass Canadian exporters and can intimidate them into exporting less than would otherwise be the case. Moreover, Canadian exporters spend significant amounts of money opposing these petitions. Full weight should be given to all these costs. Nevertheless, the facts do not sustain the claim that the United States is making frequent and increasing use of nontariff measures to restrict imports from Canada. The perception is not the reality – we are simply spooking ourselves.

CONSTRAINTS ON THE USE OF NONTARIFF MEASURES

An important, related perception is that the United States now has a free hand to use nontariff measures to restrict imports from Canada. As Canada's ambassador to the United States summarizes it, 'All the access we have is at risk'.

In fact, any country with a free hand to use nontariff measures would have made much greater use of them than the United States has done. Recall that during the last decade the Americans have seen two substantial increases in oil prices, stagflation, the most severe recession since the Second World War, relatively high unemployment, a substantially overvalued currency, the largest current-account deficit in history, intense import competition in some traditional industries that has resulted in plant closures and the layoff of employees, two presidential elections, and four congressional elections. The fact that during the last decade the United States made only limited use of nontariff measures is evidence of powerful constraints on their use additional to the announced freer-trade policies of the US government.

Most of these constraints on the United States – and on other developed market economies – derive from the GATT. In broad terms, it constrains the US government from using nontariff measures to restrict imports from Canada in three ways:

- Legal rights and obligations relating to the use and misuse of nontariff measures.

– A dispute-settlement system that normally results in expeditious, equitable settlements.

– Leverage obtained from the fact that other GATT members share Canada's interest in bringing US nontariff measures under control.

A key operating principle of the GATT is that its provisions and the bound tariffs annexed to it represent a balance of rights and obligations among signatories that should be maintained. A signatory's adopting measures inconsistent with the agreement is regarded as *prima facie* evidence that that country has tilted the balance in its favour. Unless consultations or conciliation brings about a mutually acceptable settlement of the issue, adversely affected signatories are permitted to restore the balance by suspending or withdrawing concessions or other obligations. Although retaliation is infrequent, it is the ultimate sanction, persuading governments to respect the rights and interests of exporters. The recent decision of the US government not to apply quantitative restrictions on imports of steel from all countries is an example of the disciplinary power of probable retaliation. At least the European Community (EC) and Canada would probably have retaliated – quite legally – against US exports. The high risk of such retaliation was probably the dominant reason for the American decision to negotiate voluntary export restraints with certain countries instead.

If retaliation against some action is probable or even possible, US interests that could be adversely affected normally use their political clout to oppose it. Under the GATT, an effective and accepted means of preserving market access is to establish a legal method of retaliation, prepare a list of imports that would be restricted by the retaliatory measures, and leak the list. Producers that would be affected by the retaliation are thus warned of their vested interest in lobbying against the imposition of restrictions.

Because of the dangers of legal retaliation, the United States and most other GATT countries normally try to avoid situations that would result in a GATT panel's finding that they have breached their obligations. An important consideration, for example, in the 1983 US finding that Canadian provincial governments were not subsidizing the sale of timber, was the knowledge that a GATT panel might decide that subsidies had not been granted.

These considerations suggest that the perception that the United States now has a free hand to use nontariff measures, putting 'all the access we have . . . at risk' is not the reality. The GATT places powerful constraints on the use of nontariff measures by the United States as well as by the other developed market economies. Moreover, in most disputes with the United States relating to nontariff measures, the GATT substantially increases Canada's leverage because those measures would also adversely affect imports from other countries.

UNIMPEDED ACCESS TO US MARKETS

An essential part of the case supporting a free-trade area with the United States is that its creation would either exempt Canadian exports from nontariff measures or tie the Americans' hands on such measures. Canadians would have 'unimpeded', 'assured', or 'guaranteed' access to US markets. This claim has been succinctly stated by the Senate Committee on Foreign Affairs, by Canada's Ambassador to the United States, and by *Globe and Mail* correspondent William Johnson, among others:

> As tariffs decline, the pressure from abroad, including the United States, for more effective non-tariff barriers may grow and Canada may find itself increasingly squeezed out of the US market. Only a blanket exemption for Canada, which should be negotiated as part of a free trade arrangement, could avoid this risk. (Canada 1978, 2:121)
>
> They [many Canadian businessmen] look upon this as if what we have we have pocketed, and all that we're talking about in free trade is looking at what is left. But we have pocketed nothing. All the access we have is at risk. So what we're talking about, even in sectoral free trade, and what we're talking about in total free trade is something new, something beyond what we had – because it's a way of tying the American hands on the non-tariff barriers. (Source unknown)
>
> The attraction of tying the protectionist hands of the Americans makes alluring some form of free trade agreement. At one stroke, too, it would relieve the Canadian Government and industry of constantly renewed lobby efforts to ward off attacks on Canadian imports of lumber, potatoes, raspberries, textiles, fish, onions, steel. (Johnson, September 1984)

Is this common perception reality? A few facts about nontariff measures are useful in finding an answer.

Nontariff measures can be classified in two categories:

- Those that governments retain the right to use and do use in certain circumstances. Examples are countervailing duties, dumping duties, and safeguard actions relating to imports, the balance of payments, and national security. Countervailing and dumping duties are used to prevent injurious dumping and subsidization by another country; safeguard actions are normally taken to limit a surge of imports that causes (or threatens to cause) serious injury to domestic producers.
- Those that governments may agree to eliminate. Examples are buy-national policies for government procurement and quantitative restrictions per se.

The GATT permits the use of countervailing duties, dumping duties, and emergency action on imports in appropriate circumstances. So do the Stockholm Convention of the European Free Trade Association, the free-trade agreements between EFTA countries and EC and the US/Israeli free-trade agreement. The Canada/US Auto Pact also reserves the rights of both countries to levy countervailing and dumping duties and to take safeguard actions consistent with their GATT rights and obligations. The GATT limits national treatment to internal taxation and regulations; the free-trade agreements mentioned generally limit it to internal taxation, regulations, and tariffs. Notice that neither the GATT nor these free-trade agreements extend national treatment to countervailing duties, dumping duties, or safeguard actions; in these situations, national treatment is limited to nationals of each country.

On the other hand, many countries have agreed to eliminate quantitative restrictions on imports and buy-national practices. From the inception of the GATT to the early 1960s, all the market economies except Canada and the United States sought to safeguard their balance of payments by maintaining quantitative limits on imports of thousands of products. Virtually all these quotas on industrial products as well as many on agricultural products were removed when the economies achieved a viable payments position. The Government

Procurement Agreement negotiated in the Tokyo Round lifted buy-national practices from a range of purchases.

Two other facts of life regarding nontariff measures should be noted at this juncture.

- Negotiating power - leverage - is essential to remove foreign nontariff measures. It is equally essential for bringing those that cannot be removed under effective international discipline to insure that they are not misused to increase protection.

- After nontariff measures have been removed or brought under effective discipline, leverage is also essential to insure that they are not resurrected or misused.

The consequences of these facts

Against this background, let us consider whether a Canada/US free trade agreement could include the removal of countervailing and dumping duties or safeguard actions relating to imports from Canada. If not, would it tie the Americans' hands on their use?

Removing countervailing and dumping duties

Countervailing duties protect domestic producers from being injured by subsidized imports. Canadian federal and provincial governments spend billions of dollars each year subsidizing a wide range of economic activities, such as the production and export of dairy products, the transportation of grain, the catching and processing of fish, regional development, research and development programs, and industries in financial difficulties. It is unlikely that the United States would agree to exempt Canadian products from its countervailing-duty legislation unless Canadian governments agreed to stop granting current subsidies, to refrain from granting subsidies in the future, and to accede to procedures that gave the United States enough control over federal and provincial agricultural and industrial policies to insure that subsidies were not granted in the future. (Such procedures are not without precedent. For example, the US/Israeli free-trade agreement provides that until 31 December 1990, Israel must consult with the United States before using infant-industry protective measures; after that date, it must obtain US permission before using them.)

Would the federal and provincial governments pay such a price for a blanket exemption to US countervailing duties? To the extent that Canadian governments continued to grant subsidies and to retain the right to grant them in the future, it is likely that the United States would retain the right to levy countervailing duties on subsidized imports from Canada.

Another consideration is that US governments spend many billions of dollars more than Canadian governments to subsidize a wide range of economic activities. These subsidies, like Canadian ones, are designed to meet perceived national and regional interests – which sometimes diverge from or conflict with Canadian interests. It is unlikely that US governments would agree to eliminate many such subsidies (for example, those granted high-technology industries through defence programs). To the extent that they would not, Canada presumably would want to retain the right of countervail.

It is even less likely that either government would exempt each other's imports from dumping duties. Dumping, unlike subsidization, is initiated by the private sector, and it is difficult to envisage how either government could undertake that its private sector would not dump. As long as dumping is possible, both governments would wish to retain the right to levy duties against dumped goods that caused or threatened injury. Even in the hypothetical situation of the United States' making an exemption, would Canada be willing to leave its domestic producers defenceless against injurious and possibly predatory dumping by US producers, who generally have much greater resources than Canadians to cover the costs of dumping?

A way out on safeguard actions?

As noted above, a number of free-trade agreements, as well as the GATT, include provisions permitting safeguard actions, as well as countervailing and dumping duties. For reasons similar to those discussed above, it is unlikely that safeguard provisions would be eliminated in a Canada/US free-trade agreement. It might, however, be possible to include a provision similar to the one in the US/Israeli agreement.

> When, in the view of the importing Party, the importation of a product from the other Party is not a significant cause of the serious injury or threat thereof . . . the importing Party may

> exempt the product of the other Party from any import relief that may be imposed with respect to imports of that product from third countries, taking into account the objective of achieving bilateral free trade as embodied in this Agreement, the domestic laws and international obligations of the Parties. (Article 5, par. 3)

Notice that under this provision the United States 'may exempt' imports of a product from safeguard action if 'in [its] view' the imports are 'not a significant cause' or threat of serious injury, 'taking into account' US laws and international obligations.

A similar provision in a Canada/US agreement would be a retrograde step because we would be giving up the right to compensation and/or retaliation, which are our most effective defensive levers against US safeguard actions. We would also be giving the United States a lever that could be used to extract additional postnegotiation concessions from us. Moreover, such a provision would probably result in the reversal of our GATT position of supporting the nondiscriminatory application of safeguards. Over time, such a move would result in an increase in safeguard actions by other countries, restricting our exports. Finally, would it be in Canada's interests to cede its right to take safeguard action against injurious imports from the United States – a right that Canada does invoke from time to time?

Tying the Americans' hands?

Inevitably, the provision of a free-trade agreement relating to nontariff measures would be open to interpretations, and those of the Canadian and US governments would conflict from time to time. Preventing the use of nontariff measures to increase protection would, therefore, require a dispute-settlement system that would neutralize Canada/US disparties in power and result in expeditious, equitable settlements.

In more than a hundred years of commercial relations, Canada and the United States have not developed such a system. Efforts to settle disputes normally comprise bilateral discussions and negotiations between government representatives. In cases involving the misuse of trade restrictions, the US representative has, on occasion, used the option to procrastinate, imposing very substantial costs on Canada.[4]

Not infrequently, disputes have never been settled or have remained open for many years.

Canada's entering a free-trade agreement with the United States would, in effect, take US nontariff barriers against imports from Canada out of the GATT, preventing us from using the GATT dispute-settlement system and cutting us off from the additional leverage we obtain from coincidental interests with other GATT members. In other words, Canada would be isolated in one-on-one situations with the United States. We would thus have to accept US interpretations of American obligations and Canada's rights relating to any nontariff measure that it applied to Canadian goods and services. Without the constraint of a possible appeal to a GATT panel, US officials would have considerable latitude in interpreting obligations and rights. This latitude, in turn, would make US officials very vulnerable to pressures from American interests to give interpretations favourable to them and contrary to Canadian interests. For decades officials of the developed market economies, including the United States, have cited GATT provisions literally hundreds of times a year to deflect domestic interests' requests for increased protection. The creation of a free-trade area would remove this defence.

Rather than tying the Americans' hands, a free-trade agreement would untie them, giving the United States much more latitude than it now has to use nontariff measures to restrict imports from Canada.

Some illustrations

The risk of the United States' making greater use of nontariff measures under a free-trade agreement than under the GATT can be illustrated by reference to recent disputes involving lumber and petrochemicals.

Lumber

In December 1982, the United States Coalition for Fair Canadian Lumber Imports, an organization of timber producers, mostly in the Northwest states, submitted a petition to the US government alleging that Canadian provincial governments (especially those of British Columbia, Alberta, Ontario, and Quebec) were subsidizing the sale of timber by 60.7 per cent of the unit value of lumber exports and requesting the levy of countervailing duties. After a lengthy examination, the United States found that provincial governments were not granting subsidies. Important considerations in making this finding were that under GATT definitions there was a strong case that the provincial governments were not granting subsidies, that in the event of an unfavourable finding the Canadian government would almost certainly request GATT to establish a panel to examine the issue, and that the panel probably would find in Canada's favour. Without these GATT constraints, there would have been a much higher risk of the United States' deciding to accommodate its own vested interests and find justification for levying countervailing duties on lumber imports from Canada.

Petrochemicals

In the late 1970s, the EC complained that US controls on the price of natural gas granted subsidies to producers of derived products, such as petrochemicals and synthetic textiles, providing exporters of these products with an artificial price advantage. Subsequently the EC asked the United States to consult with it under the GATT. The Americans argued that their pricing system for natural gas did not grant subsidies and was consistent with the United States' GATT obligations. The EC dropped its complaint, invoked GATT article XIX, and placed quantitative restrictions on the United Kingdom's imports of US polyester, filament yarn, and nylon carpet yarn.

At a 1984 conference of the Canadian Manufacturers' Association (CMA), Deputy United States Trade Representative Michael Smith indicated that his country had changed its position, stating, 'Government regulation of the pricing of energy feedstocks is a non-tariff issue which could surface in any discussion of the petrochemical sector'. Since there is a very strong case that the Canadian system of controlling the price of natural gas is consistent with its GATT obligations, the US government is unlikely to find that these controls grant a subsidy – as long as the GATT applies. In a Canada/US free-trade area, however, the GATT would not apply, so there would be a high risk that the United States would find that Canadian control of natural-gas prices grants a subsidy and would levy countervailing duties on imports of petrochemicals and other gas-intensive products from Canada.

The reality

Thus, it is not realistic to assume that a Canada/US free-trade agreement would provide Canada's exports with a 'blanket exemption' from nontariff measures. Although the two governments might agree not to grant certain subsidies (or not to grant them to certain sectors of production) and not to apply safeguard measures to each other's exports in certain circumstances, both would probably retain the right to use a range of nontariff measures, including countervailing duties, dumping duties, and safeguard measures. Such a result would give the United States much more latitude than it now has to use nontariff measures to restrict imports from Canada.

How would Canada respond to the United States' increasing that use? Since Canada would be cut off from recourse to the GATT, it would have four alternatives:

- Accept the nontariff measures and the loss of trade they would bring about.
- In dumping- and countervailing-duty and product-standard cases, adopt US practices.
- Retaliate and possibly create a crisis in Canada/US relations.
- Use extra trade concessions to pay the United States to remove the restrictions – in other words, obtain market access on the instalment plan, which the British call the never-never.

As individual Canadians gradually realized that 'unimpeded', 'assured', or 'guaranteed' access was an illusion and that they were getting the short end of the stick and would continue to get it because of the United States' greater power, would they shift the focus of their attention from Ottawa to Washington? Would they eventually seek representation in the US political system?

BALANCE OF ADVANTAGE

Another perception that should be examined is that the United States would believe that an exchange of normal trade concessions would provide it with a balance of advantage – in other words, that the cost to Canada of obtaining a blanket exemption from, say, US countervailing duties, would be providing the Americans with a symmetrical exemption from Canadian countervailing duties. This perception is more implicit than explicit in the literature; nevertheless, it exists and is part of the case for a free-trade area.

In fact, the cost of obtaining a blanket exemption from or scaled-back concessions on US nontariff measures probably would be substantially more than a symmetrical exemption of US exports from Canadian countervailing duties. It would be prudent to anticipate that the Americans would not regard freer access to a market of 25 million consumers as adequate compensation for symmetrical concessions to a market of 225 million consumers. Therefore, they would ask Canada for additional concessions to establish a balance of advantage, and those concessions would inevitably be outside the field of normal trade concessions.

It would also be prudent to anticipate that the United States would apply this approach across the whole range of issues under negotiation – tariffs as well as other nontariff measures. As noted above, a US spokesman has already signalled that his country now regards energy price controls as a potential nontariff issue in the petrochemical sector. In the same speech, Ambassador Smith also warned, 'Treatment of foreign investment under a prospective sectoral free trade arrangement is of particular concern to the United States'. Other probable targets for US requests, in my view, would be policies relating to radio and television and to water and in the service sector, laws and regulations that impinge on the right of establishment.

Illustrations

The probability that the United States would regard a Canada/US free-trade area as asymmetrical can be illustrated by reference to the Tokyo Round negotiations of the GATT agreement lifting buy-national practices. In those negotiations, it was estimated that the Canadian entities placed under the agreement would purchase about $1 billion of goods and related services a year whereas the US entities would purchase about $18 billion. This gap was acceptable to the Americans because it was bridged by purchases by third-country entities. In negotiating a free-trade area, however, the United States probably would request that Canada match, dollar for dollar, the purchases of the US entities to be covered or close the gap with extra trade concessions. Since any symmetrical inclusion of entities (federal only; federal and state and provincial; federal, state and provincial, and municipal) would, in the US view, leave a substantial payment gap, it would be prudent to assume that Canada would end up lifting virtually all buy-Canadian practices, while the United States retained the right to buy-American practices for the purchase of substantial amounts of goods and services, or making extra trade concessions. In brief, Canada cannot afford to negotiate bilaterally the lifting of buy-American practices.

The advantages of negotiating with the United States within the GATT can be further illustrated by noting that in the Tokyo Round, the Americans made a number of other important nontariff-measure concessions of value to Canada that we could not have obtained on a bilateral basis or for which we would have had to pay an exorbitant price. They included:

- An undertaking not to attach buy-American riders to financial assistance to state and municipal governments for the purchase of civil aircraft and components.
- An agreement to apply an injury test before levying countervailing duties.
- The adoption of a new, less restrictive system for establishing the value of imports for customs purposes.
- The abolition of the 'American selling price', the 'wine-gallon assessment', and the 'final list' methods of valuing certain imports.

Again, the perception is not the reality.

GATT

Another frequently encountered perception is that there has been a general increase in protection that has, in turn, impaired the GATT. Joe Clark, secretary of state for external affairs, recently expressed this view:

> The new protectionism is much less transparent, more insidious and very much more difficult for the exporter to deal with on his own. It is applied through a variety of non-tariff measures at the border, such as so-called voluntary export restraints, orderly-marketing arrangements and changes in technical standards. And then, often lying behind these bar-

> riers, are industrial and structural measures, of taxation, subsidization, regulation and purchasing practices, which have been brought in for some domestic policy reason, but nonetheless have a protectionist effect. All of this amounts to a serious erosion of the open multilateral trading system so carefully built up over the past 40 years – an erosion of the system you exporters need to keep your markets open. (Clark 1984)

Let us examine some relevant facts.

1 None of the nontariff measures mentioned by Mr. Clark are new. Indeed, all of them have existed for decades, and some, such as taxes, subsidies, and restrictions on government purchasing, have been around for centuries.

2 The use of nontariff measures by the ten developed market economies, before and since the inception of the GATT, can be described as follows:

– Before the GATT, they all used a wide range of nontariff barriers to limit or prevent imports, frequently applying these barriers on a discriminatory basis.

– To date, most of these countries continue to use nontariff measures, usually across the board, to restrict and/or subsidize trade in a limited number of commodities, such as arms and munitions, shipbuilding, dairy, and grains and poultry. Recently, the use of subsidies has expanded in areas such as regional development, restructuring in certain sectors, retraining, research and development, and redeployment of industry to avoid congestion and environmental problems.

– From the inception of the GATT, until the early 1960s, all the countries except Canada and the United States maintained thousands of quantitative restrictions to limit imports of various products.

– During the last twenty or thirty years, all the developed noncommunist countries have also used nontariff measures to shelter their textile, clothing, and footwear industries from competition from low-cost producers located mostly in developing countries. In 1964, the United States also embargoed imports of uranium, and it still uses restrictions to limit them.

– Since the mid-1970s, some industrialized market economies have used nontariff measures to limit imports of additional products. It is important to note, however, that these measures have been used by a relatively small number of countries for a relatively small number of products (although these products are generally important in international trade). Many of the measures apply only to Japan's exports and not to exports of the same or similar products by other countries.[5]

3 Since the inception of the GATT, the following developments have achieved the elimination of thousands and thousands of nontariff measures and brought many others under international discipline to prevent their misuse:

– The GATT provisions directed at establishing tariffs as the only legal means of protection have brought about the elimination of thousands of quantitative restrictions, as well as internal taxes and other charges, laws, regulations, and requirements that afforded protection to domestic products. The discriminatory application of such measures has also been eliminated in many cases.

– The GATT contains provisions directed to preventing the use for protective purposes of a number of nontariff measures that cannot be eliminated. These provisions cover valuation, antidumping and countervailing duties, freedom of transit, fees and formalities connected with importation and exportation, marks of origin, publication and administration of trade regulations, and state trading enterprises.

– In the Kennedy Round, the provisions relating to antidumping duties were updated, and Canada agreed to apply an injury test to dumped imports before levying duties.

– In the Tokyo Round, product standards and government purchasing preferences were, in effect, brought under the GATT by the Technical Barriers to Trade Agreement and the Government Procurement Agreement. Signatories of the former have expressed general satisfaction with its operation. It has had a marked impact on the work of bodies establishing and modifying standards and has resulted, *inter alia*, in Japan's revising sixteen domestic laws on standards and certification measures and procedures. Signatories of the Government Procurement Agreement have been purchasing under it approximately $40 billion of goods and related services during each of 1981 and 1982; the United States purchased $22 billion and Canada $500 million annually. Negotiations have been initiated to expand the coverage of the agreement.

– Four additional agreements were negotiated in the Tokyo Round to update provisions preventing the use for protective purposes of valuation, dumping and countervailing duties, and import-licensing procedures.

4 As a result of GATT negotiations, the industrial tariffs of the ten developed market economies are substantially lower than during the 1930s and probably lower than at any time since the late 1870s. The average US tariff during the early 1930s was 50 per cent; after the Tokyo-Round reductions are fully implemented, the US tariff on dutiable industrial imports will average approximately 4 per cent, the EC tariff 6 per cent, the Japanese tariff 5 per cent, and the Canadian tariff 9 per cent.

The magnitude of the trade liberalization being brought about by the Tokyo Round tariff reductions can be illustrated by a few statistics, all based on 1976 data. In that year, the most-favoured-nation imports of industrial products by the ten industrial market economies totalled $190 billion. About $60 billion (32 per cent) of them were already duty-free. Tokyo Round negotiations agreed on reductions for $112 billion (86 per cent) of the remaining $130 billion. These reductions are of the order of 33 per cent on a weighted duty-collected basis (38 per cent on a simple arithmetical average of duties). Tariffs on imports valued at $56.5 billion were guaranteed duty-free, increasing total duty-free imports to $66.5 billion (35 per cent). Virtually all the industrial tariffs of these ten countries are bound against increase in their respective GATT schedules. If all the tariff reductions had been implemented in one step (that is, with no phasing in), the ten economies would have forgone more than $4 billion of tariff revenue.

Agriculture and fish imports by the ten economies totalled $48 billion in 1976. A significant portion was already duty-free. The Tokyo Round reduced tariffs on nearly $15 billion of imports (31 per cent); the average trade-weighted reduction was of the order of 40 per cent.

5 World exports of goods increased from $154 billion US in 1963 to $574 billion US in 1973 and $1.8 trillion US in 1983. Export growth has exceeded the growth of production throughout this time, except for the odd period.

6 Canada's exports of goods to the world increased from $7 billion Canadian in 1963 to $25.5 billion in 1973 and $88.5 billion in 1983. Generally, export growth has exceeded the growth of production.

7 Apart from the EC restrictions on agricultural and fish products, relatively few of the current nontariff measures have had a seriously adverse effect on Canada's economy (the US embargo on uranium has probably caused the most damage). Of the 'new' protectionist measures, technical standards limiting Canada's exports are probably fewer than they were before the Tokyo Round, and, as we have seen, governments are annually awarding contracts valued at about $50 billion that previously were subject to buy-national practices. Since Canada removed restraints from exports of oil in the 1960s, it has voluntarily restrained exports of only one category of industrial products (certain steel products). Indeed, the voluntary export restraints that now adversely affect Canada's interests are maintained by other countries at Canada's request.

Since it is not possible to measure accurately in mathematical terms the increases and decreases in the use of nontariff measures, any conclusions relating to Mr. Clark's perception must be judgements. I suggest that, from the inception of the GATT to the present, there has been a substantial net reduction of protection – in the use of nontariff measures as well as in the tariff levels. I also suggest that during the past ten years – a period that has included two oil shocks, years of stagflation, and the most protracted recession experienced since the Second World War, not only has there been no net increase in protectionism but there has been a significant decrease, including the use of nontariff measures. The additional barriers imposed during this period appear to have been more than offset by the reductions in nontariff measures and tariffs brought about by the Tokyo Round. Many of the additional nontariff measures are those of a relatively small number of countries to limit imports of a relatively small number of products, many of them from Japan. In contrast, virtually all the Tokyo Round agreements relating to nontariff measures apply to all imports (or all imports of a product or group of products) from all signatories of GATT or the signatories of a particular agreement. Moreover, some of the new nontariff measures provide some scope for imports to increase from year to year. For example, despite restrictions on imports of automobiles and parts from Japan, that country's exports to North America increased by 19 per cent and to Western Europe by 20 per cent between 1982 and 1983.

Thus, perception of a 'new protectionism' and 'serious erosion' of the GATT is not the reality.

New GATT negotiations

It is now virtually certain that a new round of GATT negotiations (MTN 8) will be initiated in 1986. The rules for MTN 8 likely will permit negotiations relating to any product, a range of services, and barriers to the import or export of such products and services. The negotiations probably will include all the Tokyo Round issues plus certain services and more substantive negotiations relating to agricultural, fish, steel, motor vehicles, textiles and clothing, and technologically advanced products. The new round likely will be larger, more complex, and more onerous than the Tokyo Round (which, in turn, was much larger, more complex and onerous than the Kennedy Round).

MTN 8 will provide Canada with another opportunity to negotiate improved, more stable access to virtually all its export markets, including the United States, at prices we can afford to pay. For negotiating nontariff measures, as well as virtually all other trade issues, the window of opportunity is in Geneva, not Washington.

THE FEDERAL DISCUSSION PAPER

A review of the federal government's discussion paper (Kelleher 1984) suggests that the objective is a 'comprehensive arrangement' – the paper's preferred option – that would provide comprehensive national treatment. Elaborating, the paper refers to a 'comprehensive agreement which provide[s] for the removal of tariffs and non-tariff barriers on substantially all bilateral trade'. It states, 'The main problem for Canadian access to the US market is increased threats of protectionist measures', and notes, 'In recent years, Canadian producers in many sectors ... have experienced the uncertainty and harassment of threatened or actual US restrictions.'

Unfortunately, the discussion paper does not explain how the government would obtain comprehensive national treatment on nontariff measures – for example, it has no explanation of how US countervailing duties, dumping duties, or safeguard measures could be lifted from Canada's exports. Indeed, it does not even place comprehensive national treatment in its historical context, which would give a reader at least some understanding of the far-reaching nature of this objective and the prospects of achieving it on terms acceptable to Canadians. I am aware of no historical precedent in which two countries with the disparity of power that exists between Canada and the United States exchanged comprehensive national treatment on nontariff measures and the weaker country retained its sovereignty. Comprehensive national treatment has not been exchanged in the EFTA or the EC.

Nor does the discussion paper explain, even in general terms, how the government could end the main problem – the threats of new protectionist measures. Since most of these threats surface in bills tabled in Congress, it would be useful to know how a Canadian government could stop them. A modicum of realism suggests that Canadians will have to continue to live with such threats.

The discussion paper also fails to discuss, again even in general terms, the cost of obtaining comprehensive national treatment for nontariff measures. By omitting this subject, the paper leaves the impression that the United States would regard a symmetrical exemption of its exports from Canadian nontariff measures as providing a balance of advantage. In my view, this expectation is not realistic. Given the disparity of market size, the United States would ask Canada for additional concessions – inevitably, outside the field of normal trade concessions – to establish a balance of advantage.

It is most unfortunate that the paper does not discuss the cost of obtaining an exemption from specific nontariff measures, such as countervailing duties and buy-American practices. After all, a discussion could be carried some distance simply on the basis of the nature of the specific nontariff measures, their purposes, and experience in past negotiations. For example, as I have suggested, it is unlikely that the United States would agree to exempt imports from Canada from countervailing duties unless Canadian governments agreed to phase out existing subsidies and to accept procedures that would give the Americans control over federal and provincial agriculture and industrial policies sufficient to insure that subsidies are not granted in the future.

Since the discussion paper does not assess the prospects and costs of achieving its objectives through a bilateral free-trade agreement, it could not, of course, compare these prospects and costs with those of achieving its objectives under the GATT. Yet it seems essential to make such an asssessment before the government makes decisions relating to a 'comprehensive arrangement'.

It is also unfortunate that the discussion paper does not present other relevant and important information that would have assisted a reader to understand the issue better and that could have been included without unduly lengthening the document. Examples of such information are:

- That the United States has made limited use of nontariff measures to restrict imports from Canada.

- That signatories of the GATT Government Procurement Agreement lifted their buy-national practices from contracts valued at $40 billion in each of 1981 and 1982.

- That in 1971 Parliament enacted the Employment Support Act to provide 'financial assistance to the Canadian manufacturing industry for the purposes of mitigating the disruptive effect of the imposition of foreign surtaxes, or other measures of like effect, where such measures could seriously affect employment'. That act, which was used to sustain 21,944 jobs when the United States levied surcharges on imports in 1971 and which is still law, could be used to help Canadians adversely affected by foreign-trade restrictions in the future.

The usefulness of the discussion paper

These observations raise questions about the utility of consultations conducted on the basis of a paper that is incomplete and inadequate for the achievement of the objectives said to include 'consider[ing] ways and means to address' market access problems and 'establish[ing] a basis for decisions on the best strategies for achieving Canadian market access objectives identified in these consultations' (Kelleher 1984, 1, 2).

A final observation is related to establishing a basis for strategic decisions. If the discussion paper reflects the level and quality of the work that has been done officially on nontariff measures, I suggest that the government is, at a minimum, many months from the time when it can have assembled and placed before it an adequate basis for decisions on nontariff measures that affect trade not only in industrial products but also in agricultural products and services.

NOTES

1 They are substantially lower than during the early 1930s, when the average US tariff was 50 per cent; after the Tokyo Round cuts are fully implemented on 1 January 1987, its average industrial tariff on dutiable imports will be 4 per cent.

2 Protected products after full implementation of the Tokyo Round cuts will include rapid-transit and railroad equipment, resins, textiles, apparel, footwear, and certain ceramic articles.

3 Products imported from Canada that were restricted were methyl alcohol; clothes pins; bolts, nuts, and screws of iron or steel; sugar and syrups; optic-sensing systems; spring assemblies, components, and production methods; stainless steel; and chlorine chloride.

4 An example is the US embargo and restrictions on imports of uranium.

5 The important nontariff measures used since the mid-1970s are: the restrictions Canada, the United States, and some EC countries apply to imports of Japanese motor vehicles; the restrictions the United States and some EC countries apply to imports of Japanese motorcycles; the restrictions some EC countries use to limit imports of certain electronic products from Japan; EC and US restrictions on imports of a range of steel products and ball bearings from all countries; and the restrictions Japan applies to imports of leather and silk from all countries.

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Discussion

QUESTION: Mr. Clark, you didn't touch on the perceived prevalence of buy-American preferences at the state level. For example, many colleges and universities have to buy within their own states or have their grants reduced. Also, some Canadian exporters say that they're encountering a buy-American attitude in the private sector. That has nothing to do with legal requirements. How effective has the GATT been in dealing with either of these situations? Do you think bilateral trade liberalization would have any impact on them?

MEL CLARK (Melvin G. Clark & Associates Limited, Ottawa): Well, the early drafts of the GATT covered government procurement, but those provisions were subsequently removed at the insistence of the United States. The matter remained entirely outside the agreement until the Tokyo Round, and that agreement covers only part of the area, although, as I have noted, contracts valued at $40 billion were let under it in each of 1981 and 1982.

The current negotiations initiated in Geneva are directed to expanding the coverage. Personally, I think that it could be expanded quite significantly. For example, I think it would be possible to bring in hydroelectrical generating and transmission systems, telecommunication systems, and railway and rapid transportation systems. Many of these goods and related services are purchased by provincial or state or municipal entities. I don't say achieving this expansion would be easy, but given the proper priority and effective management, I think it could be done. For government procurement as well as other nontariff measures, the window of opportunity is in Geneva, not Washington.

Turning to the part of your question regarding buy-American attitudes in the private sector, it is difficult to envisage how any contractual agreement between governments, bilateral or multilateral, could lift such attitudes.

PART IV: THE MAINTENANCE OF POLITICAL INDEPENDENCE

Canada/US free trade and Canadian economic, cultural, and political sovereignty

B.W. Wilkinson

Even without bilateral free trade (BFT), the economic, political, and cultural integration of Canada with the United States has been increasing. With BFT, this integration would increase even more. Complete political integration with a free-trade partner is not an impossibility; contrary to what some would have us believe, it has happened before. Whether it ever happens to Canada will depend upon how well we bargain should we enter a BFT arrangement with the United States and, more importantly, upon that country's expectations, goodwill, and as yet undeclared motives.

This paper discusses these matters in the order set forth. It concludes with some observations on how we might minimize the possibility of complete political absorption into the United States – if avoidance is what our society really wants.

THE TREND TOWARDS INTEGRATION WITH THE UNITED STATES

Although Canada has, from time to time, given considerable lip service to diversifying its foreign trade, most recently in the direction of the Pacific Rim countries, the facts suggest that the nation has generally taken the easiest route – which is to increase trade with the United States. Since the Second World War, Canadian exports to the United States have risen from 38 per cent of our total exports to 76 per cent.

Professor Wilkinson is a member of the Department of Economics, University of Alberta, Edmonton.

A number of Canadian policies have helped to bring about this increased dependence upon the US market. Certainly the 1965 Auto Pact has been responsible for a major expansion of trade between the two nations. In addition, our macroeconomic policy of slavishly following US interest-rate changes and not permitting our currency to decline nearly as much as have most European countries has meant that we have become less competitive in third-country markets. Under these circumstances, our proximity to the United States has made it the easiest market in which to sell. Again, the National Energy Policy was designed to redistribute the benefits from Western Canada's oil and gas to Ottawa and Central Canada generally and to reduce foreign ownership. The results included, *inter alia*, an excessive slowdown in economic activity in the oil and gas industry with adverse economic effects upon all of Canada, so the nation became even more dependent upon US growth to increase aggregate demand via exports south of the border. Concurrently, while the incentives to reduce foreign ownership diminished European participation in the oil industry, the US segment of the industry survived and prospered and, if anything, became more securely entrenched in Canada than ever. At the same time, many Canadian firms were very adversely affected and greatly weakened (Petroleum Monitoring Agency 1983).

Canada's trade relationship with the United States has often been one of reacting to its policies, either defending Canadian interests, as with lumber and steel exports to that nation, or accommodating ourselves to its wishes, as with the lowering of natural gas prices (which some US interests now want raised again, apparently because the competition is more than they wanted) or with the relaxing of various rules of the Foreign Investment Review Agency.

Culturally, the integration of Canada into the United States is so great that one has to ask what it is that we are attempting to preserve. We are already engulfed in American movies, books, and magazines. With cable and satellite reception of television, nothing there is denied Canadians. American sports are Canadian sports. All American news of any significance is reported in the Canadian news media. Sunday opening of stores is spreading rapidly, and if some interests have their way, wide-open casino gambling will be next. Fortunately, Canadian cities still remain safer than those in the United States, and a greater general respect for authority probably continues in Canada. We also have the French-Canadian culture. But by and large, the remaining differences between the two countries in many spheres are probably no greater than the differences persisting between regions within the two nations.

Integration in the political realm has been proceeding apace with the economic and cultural integration. Increased consultation between the two federal governments on a wide range of issues has occurred increasingly in recent years. Legislation in Canada, whether it is the lowering of natural gas export prices or the relaxing of FIRA rules, reflects US political pressures.

BILATERAL FREE TRADE AND INCREASED INTEGRATION

There can be little doubt that a BFT agreement with the United States would augment the integration with that country that already exists and is continuing to occur. Certainly, trade flows between the United States and Canada would increase, just as they have done under the Auto Pact, although perhaps not as dramatically. There could also be diversion of trade from third-country markets in textiles, furniture, machinery and equipment, and the like.

The proportion of Canada's trade with the United States would likely rise substantially. There would be increased pressure on Canada for tax harmonization to prevent our taxes on industry from being either higher than those in the United States, a situation that could discourage the location of industries in Canada, or lower than those in the United States, a situation that might allow the Americans to accuse Canada of subsidizing industry in some way and thus make our exports subject to countervail. Under BFT, the United States would likely have something to say about Alberta's subsidies to the petrochemical industry via cheap feedstocks and Quebec's subsidies to the aluminum and other manufacturing sectors via low-priced hydroelectricity prices. More generally, it might demand assurances from Canada about natural-resource pricing and about supply of exports of resources or of products using Canadian resources. Canada's freedom to enter cartels with respect to mineral production might be limited, too. One has to wonder if BFT would mean that Canada would also have to route proposals for regional development grants and the like through the appropriate US offices to ensure that they would not violate US views of what is appropriate and what is not.

These are all matters that presumably would have to be resolved in the bargaining process. But it is difficult to imagine that, however they were resolved, the results would not place greater restraints on Canadian policy formulation in both the economic and political spheres.

It is highly probable as well that in the short run US ownership and control of industry in this country would expand as a consequence of BFT. In many sectors, US firms, on average, are larger than Canadian firms, have greater financial strength and borrowing power, enjoy more research and development (R&D) capability, and already have much international marketing expertise and many marketing channels in Canada and the United States; hence they would be better equipped to take advantage of reduced trade restrictions than would average Canadian firms. US firms might well take over ailing Canadian firms.

Some observers argue that in the long run BFT would diminish foreign ownership and control because, as Canadian-based production rationalized and became more efficient, capital/output ratios would decline and income and savings would expand. However, a decline in foreign control would not necessarily follow. A significant proportion of the increased income and savings would be foreign-owned. More important, although expanded personal and institutional savings might well result, that might mean only the purchase of more minority-equity interests in foreign-controlled firms or more Canadian lending to foreign firms, not any diminution in foreign decision-making authority. This, in turn, would mean even more concentration in the United States of final decisions on R&D, product development, production, and world marketing strategies (Wilkinson 1980).

Part of the US interest in BFT is undoubtedly a desire to see trade in all manner of services liberalized between the two countries. What this might mean for informatics, general communication, advertising, consulting, and personal services is anyone's guess at this stage. But it would certainly mean greater economic and likely cultural integration.

POLITICAL INTEGRATION

Before analysing what BFT might mean for the future cultural and political independence of Canada, it should be noted that, from a Western Canadian perspective, the current Mulroney government, through actions such as the Newfoundland and Western energy agreements, has unified Canada and thereby helped to reduce the possibility of willing, increased Canadian political integration with the United States The divisiveness generated among the various provinces of the country and between the provinces and the federal government during the latter Trudeau years by the centralizing attitude and actions of Ottawa (with support from Ontario, particularly with respect to energy policy) and by Trudeau's preoccupation with bringing home the Constitution and giving the people a new bill of rights, supposedly to enhance our freedom and independence in some mystical way, served not to strengthen the Canadian federation but only to make those outside Central Canada feel that some eventual closer political affiliation with the United States could not be worse than what we already had and would probably be better.

That being said, I suggest Canada's future political sovereignty depends upon two things: first, how well it bargains now in any bilateral trade-liberalization agreement that may be made; and second and much more important, the United States' motives and its as yet undisclosed plans and aspirations regarding Canada in the future. Consider these in turn.

Canadian bargaining

There are a host of issues to be resolved in any bilateral negotiations. Would the United States be prepared to exempt Canada from import surcharges that it might wish to impose to reduce the huge deficit on its trade account? The United States now sees Japan's sizeable trade surplus as intolerable and is considering steps of one sort or another to reduce it. Would Canada's $20 billion trade surplus be exempt? Or would the United States expect to see it reduced in any BFT agreement? Would Canada be exempt from US laws permitting the imposition of countervailing duties or other such restrictions? Would the American states be required to exempt Canada from their 'buy-domestic' rules and from their restrictions on foreign investment of various types? Would Canada be free from all the other blocks to trade that US rules and regulations permit? There is no need to spell these issues out in any greater detail. Most of them are well known.

In turn, would Canada have to give up all 'buy-domestic' policies? All pressures for product mandating and domestic R&D by foreign subsidiaries? All ability to make regional development grants (unless approved by US authorities)? All control of resource pricing, including the pricing of resources used in manufactured products being exported to the United States? All low-interest loans to help Canadian companies revamp their operations to take advantage of access to the large US market? All control over services trade in all its forms?

Undoubtedly, what each country gave up and received in turn would depend upon the skill, staying power, and expectations of the negotiators of both countries. This is where Canada would have to be careful. If we have an inflated view of the gains we expect to make via economies of scale in manufacturing, we could easily end up giving away much more than we should on other matters, such as those outlined above. The net gains from BFT could then be much less than most people had envisaged, and disillusionment could easily set in. The relative lack of unionization in the American South and fear of a BFT agreement's being abrogated might cause more than a proportionate share of new industrial investment to be attracted to the United States.

Then the idea of having more than just professional lobbyists in Washington might have considerable appeal in Canada. Why not have some members in the House of Representatives and the Senate? Political integration would make Canadian migration to where the jobs are even easier than it would be under BFT.

US aspirations and policies

Whether the previous scenario might become a realistic one depends much upon US motives, aspirations, and policies.

One view tends to downgrade the importance of US responses. Its proponents argue that Canada would be much stronger economically once a BFT arrangement were made. Our manufacturing sector would be rationalized, and longer production runs would be achieved along with greater competitiveness. Thus, Canada would be better able to withstand US abrogation of a BFT treaty. Moreover, Canada supposedly would have the ability to tax more heavily US direct investment in this country or to withhold resource exports and would thus be in a strong position vis-à-vis the United States should it wish to abrogate (Canada 1982a).

This is pure speculation – or just wishful thinking. First, rationalization across the border could easily result in Canada's producing standardized lines for which the technology was widely known. Such products are often in the low-growth end of the market. The more technologically advanced, rapid-growth end of the market might be increasingly supplied by the US parent firms. This has already happened, even without free trade, in the mining machinery and equipment business. The cross-border rationalization that has transpired has left Canada producing only one-quarter of the sophisticated mining machinery and equipment used in this country, compared with one-half of it some twenty years ago (Canada 1982b, 113-19). If this type of thing happened across a wide segment of manufacturing, what position would Canada be in if the United States decided to abrogate a BFT treaty? With about 76 per cent of Canadian exports and nearly 90 per cent of manufactured exports already going to the United States, Canada could, under BFT, become almost totally dependent upon the US market for export revenues. If the United States chose to terminate the arrangement, Canada would be in a difficult position indeed. We could not readily build up new marketing networks to replace outlets in the United States. Moreover, since what we would be producing would largely be products for which the technology was well known throughout the world, we would not easily be able to make inroads into other world markets. The newly industrialized countries are gaining an ever-stronger hold on these markets. Our vulnerability to the terms that the United States might dictate at such a time would be very great indeed.

Our ability to tax US corporations in Canada more heavily would not be much of a deterrent to unilateral US action. After all, during the time between notice of intended abrogation and the termination date, the US firms could easily withdraw their liquid assets and write down or run down other assets.

Finally, with our markets for manufactures much reduced, we would not be in any position to withhold exports of natural resources to the United States as a bargaining tool. Our precarious balance-of-trade position would probably not allow it. Notice also that the abundance of sources of most natural resources in today's world means that any monopoly power that Canada once had in resources has been sharply reduced in the last decade or so.

I argue, therefore, that once a Canada/US free-trade agreement had been operating for a number of years, Canada would be very vulnerable to unilateral actions by the United States.[1] This is why I believe that our continued political sovereignty would depend crucially upon US goodwill more than anything else. If it chose to force Canada into an annexation agreement, it would be able to bring it about in due course.

SOME HISTORICAL LESSONS

There are those who attempt to argue that a free-trade agreement has never resulted in political integration and that, therefore, the matter should not concern us. This argument is quite misleading. The Zollverein, a customs union of independent states, came into being in 1834 under the leadership of Prussia and in 1871, after the Franco-German War of 1870, led to the political union known as Germany (Ashley 1920). A customs union per se differs from a free-trade area only in that a common external tariff prevails for all member nations. All the countries of a free-trade area have to have regulations to prevent pass-throughs of products from a low-tariff country to a high-tariff one. In the Zollverein, various states kept import duties on products not on the free list and on other products for which they were protecting local monopolies or higher excise taxes. There were also internal taxes levied on the movement of goods by road, railway, or water (Henderson 1939, 266). So the history of the Zollverein is not unlike what the Canada/US situation might be under BFT.

It is of interest to read what the historians have to say about the evolution of the Zollverein. It was supposed to be an agreement of sovereign states with equal rights. But 'the threat to break up the Zollverein forced recalcitrant members' to accept Prussia's position on a variety of issues (Henderson 1939, 317-18). And with the new treaty of 1867, Prussia gained an even more dominant position than it had had before. 'On all important matters the Prussian point of view prevailed' (ibid., 315). Prussia's ability to place its stamp on the 1867 agreement was in no small way a function of its relative economic strength. Within its boundaries, Prussia had 90 per cent of the mining and metallurgical production of the entire Zollverein, 50 per cent of the textile production, and about 66 per cent of all manufacturing employment (ibid., 318). As Pierre Benaerts puts it, 'Such an industrial preponderance was bound to prepare the way for political hegemony' (quoted in ibid., 10). The south German states, which were less than enthusiastic about the union, joined the new Zollverein in 1867 by treaties that could have been abrogated. But once in the union, weaker states could not afford to opt out. Thus, it was not surprising that, with Prussian initiatives and direction, political union resulted in 1871.[2]

The path from economic to political union was not a smooth one. Various groups feared the loss of their independence in the larger union, worried about the economic and political power of Prussia, and felt their particular manufacturing or agricultural interests would be damaged. Yet in the end, the persistence of committed people – in particular, the Prussian civil servants – produced the final result they desired (Henderson 1939, 342-3).

Two lessons the historians learned from examining the Zollverein are of relevance to us today. The first is that 'the actual establishment of a customs union is only a first step towards the attainment of the objects for which such a union is founded' (ibid., 343). The second and more important one is that:

> a customs union would appear to be a half-way house. It can seldom be regarded as a permanent arrangement. Its members must sooner or later decide if they are to go backwards or forwards. Some of the early difficulties of the Zollverein were due to the fact that its members failed to see this clearly. They seem to have hoped to secure the advantages of economic union and yet to preserve a large measure of economic independence. (Ibid., 343-4)

Need one add anything to this? The skeptic may say, yes, but that was a customs union, and it involved imperialistic Prussia. We are talking about a free-trade area with the United States. The Zollverein experience is not relevant. To answer this argument, let us turn to a situation closer to home: the transition of Hawaii from a sovereign state into an economic vassal of the United States and finally into the fiftieth state.

The annexation of Hawaii

It all started very sweetly – with sugar. It was grown in Hawaii and exported to California as early as 1827. By 1850, such exports amounted to 750,000 pounds. Hawaii took the first initiatives towards reciprocity in 1848. A treaty, signed by the negotiators in 1855, covered not only sugar but also molasses, coffee, and a wide range of other agricultural products. However, the US senate did not ratify the treaty, although sugar duties subsequently were lowered modestly from 30 to 24 per cent (Tate 1968, 35, 39). In 1866, Hawaii suffered a serious depression so, once more, a reciprocity treaty was considered.

The Hawaiians recognized the dilemma they were in. They believed that a treaty would guarantee them prosperity for its initial term but recognized that if the United States chose not to renew it for whatever reasons, the islands would be in deep economic difficulty. 'Menaced by imminent ruin, would not our planters rally to the idea of annexation to the United States, which, by permanently taking off the tariff duties, would remove all fears for the future' wrote Charles de Varigny, the minister of foreign affairs (cited in Tate 1968, 50).

The US politicians (including President Andrew Johnson) were well aware of the Hawaiian position and felt in general that a treaty was the best way of preparing the ground for future annexation. The United States would not have to make the first move. Hawaiians with sugar interests would come more and more to dominate the islands' politics and would voluntarily seek annexation if the United States failed to renew the treaty after the expiration of its first term. There was some doubt about the US economic gains from a treaty with Hawaii. But 'both those who favored and those who opposed the treaty had the same ultimate objective in view – annexation of the archipelago; they differed only in the method that they thought would best achieve it' (Tate 1968, 76).

Another treaty was signed by the US and Hawaiian administrators in 1867, but after being considered a number of times in Congress, it was never ratified. (Does not this sound familiar for that period?) Finally, in 1875, a new treaty was signed and this time approved by the Senate in six weeks – but not until the legislators had added a clause prohibiting the Hawaiian king from granting any special privilege regarding land or harbours to any government other than that of the United States. The agreement provided duty-free access to the United States for nearly all Hawaiian products and to Hawaii for nearly all American commodities, including iron, steel, and textiles. The treaty was to run for seven years; then termination would be possible, provided a year's notification was given (Tate 1968, 114).

The treaty was an economic success for Hawaii; sugar exports in the ensuing two decades increased more than twelvefold. Hawaii's continued prosperity depended more and more on its access to the US market.

After the treaty was under way, interested Americans charged that it provided greater economic benefits for Hawaii than for the United States. (This charge was incorrect if all freight, shipping, banking, insurance, dividends, and so on were counted in addition to the merchandise trade flows. Nevertheless, it was used frequently.) The treaty was attacked again and again, and a campaign to abrogate it ensued, with the press playing a major role. But the US Committee on Foreign Relations, in an 1884 report, stressed the strategic position of the islands. Notice the line of argument used:

> They [the Hawaiian Islands] are east of the meridian which touches the western shore of Alaska, and may be said to be properly within the area of the physical and political geography of the United States. They are nearer to us than to any other great power. (Cited in Tate 1968, 163)

Think where Canada would fit under this type of reasoning.

During these years, the political and military implications of having Pearl Harbor began to loom somewhat larger in the United States' view (even though it had, in 1867, acquired Midway Island, which had an equally good harbour for coaling and was only a hundred miles away). At the same time, there were American concerns that Britain, via Canada, also wanted a reciprocity treaty with Hawaii – a possibility that the United States did not like. Thus it transpired that in 1887 an amendment was made to the treaty giving the Americans exclusive right to enter and use Pearl Harbor as a coaling and repair station and to improve it as they saw fit. According to the amended treaty, Hawaii was not allowed to negotiate trade arrangements with any other country.

In 1890, the United States passed the McKinley Tariff Bill, which removed US duties on raw sugar from all other countries. Thus Hawaii lost its privileged position in the US market. Therefore, it became much more favourably disposed to annexation as a solution to its situation.[3]

There were other negotiations on occasion. At one point the United States wanted added to the treaty a clause that would have allowed US forces to enter Hawaiian territory 'as may be necessary for the purpose of insuring the independence and peaceful administration of the Hawaiian Government' (Tate 1968, 226). It would have made Hawaii a US protectorate.

Meanwhile Hawaii had political problems. Its taxation system was very inequitable, placing the burden disproportionately on certain groups. Also, the government was not fully representative of the people. Near the beginning of 1892, a secret annexation club was organized in Hawaii with the knowledge and tacit support of the US administration. Various machinations followed, including, in 1893, a small revolution that involved the landing of some US troops from a warship. But these annexation efforts failed. They were clumsy and ill-conceived (Wright 1972).

During the 1890s, the debate in the United States over annexation grew more intense. Many strong interests, including some influential editorial writers, were opposed to such imperialism. Some Americans argued that it would be unconstitutional to annex the islands. Others said that some other nation would do so unless the United States did.

After William McKinley became president in 1896, some members of his party convinced him to present to the Senate a treaty involving the obtaining of Hawaii (Osborne 1981, 84). Much debate followed in 1897 and 1898. Vigorous opposition to annexation cut across party lines and economic strata:

> If there was one bond which more than any other united such disparate elements as Republicans, Democrats, Populists, silverites, labor leaders, and sugar spokesmen, it was anti-imperialism, the notion that Hawaii's admission would mark an abandonment of America's time-tested anti-colonial tradition and would embark the Republic upon the perilous course of empire. (Ibid. 1981, 107)

Nevertheless, on 12 August 1898, by a joint resolution of the Congress, signed by the president, Hawaii became a part of the United States. In the end, the Hawaiians were given no vote in the matter. The US Congress had refused an amendment that annexation should not take place unless it were supported by a plebiscite in Hawaii open to all male adults.

The change caused little stir in Hawaii for, by and large, it saw itself so dependent upon the United States that annexation appeared to be the best way to have continued free access to the US market (ibid., 132). Some Americans were less than proud of the outcome.[4]

Although proponents of annexation frequently claimed that Hawaii was needed to help the United States defend itself in war against

Spain, closer examination suggests that this reason was not really believed, even by the president (ibid., 122-3). Much more important was the use of Hawaii for US commercial interests in the Pacific.

> Commercial considerations such as the fear of the economic consequences of the manufacturing surplus, the appeal of the Asian market, the concern about the economic partitioning of China by rival powers, the dramatic upturn in American foreign trade in mid-1898, and the hope of enlarging the American-Hawaiian commerce, were more decisive in bringing about the defeat of the anti-annexationists. (Ibid., 134)

This annexation was the first in a series of imperialistic moves by the United States; within about seven months it also obtained Guam, the Philippines, Puerto Rico, and Wake Island. Hawaii was just the beginning of the US shift from isolationism to imperialism.

Analysis of the Hawaiian experience

A number of things are noteworthy about the Hawaiian experience. First, when the Hawaiians began entering the reciprocity agreement, they recognized that if they were not to become ever more dependent upon the US market, they would have to diversify their exports. Yet they did not do so, and thus they found themselves relieved by annexation for it took away their anxiety about continued access to the US market. Would Canada be able to diversify its markets as a consequence of greater efficiency achieved through Canada/US free trade? It is interesting to note that expansionist members of Congress back in the 1860s favoured abrogation of the Elgin-Marcy Reciprocity Treaty between Canada and the United States because they believed 'that the resulting dislocation of Canadian commerce might quicken natural impulses for voluntary annexation' (Tate 1968, 49). Our exports to the United States were then only about 40 per cent of all our exports, so we were not too vulnerable. The proportion is much higher today, and we would be that much more vulnerable after a BFT agreement.

Second, after reciprocity had made Hawaii dependent upon the US market, the United States reduced its tariffs on imports of sugar (Hawaii's dominant export) from all other nations, thus eroding the island's favoured position and reducing returns to producers there. Is Canada prepared to accept the fact that the United States would probably hope to lower trade restrictions multilaterally in due course? Any trade diversion that Canada had enjoyed in US markets would be removed. Would we then (or previously) be prepared to move aggressively into other world markets?

Third, the inequitable tax system within Hawaii and the lack of representative democracy made the islands ripe for change, even if change meant being annexed by the United States. Can Canadian federal and provincial governments work together with a unity of interest and mutual respect and understanding so that segments of the country do not become so disillusioned about being heard in Ottawa that they see union with the United States as an alternative that is somewhat unknown but worth trying?

Fourth, when US commercial and/or military interests are at stake, that nation is prepared to depart from its traditional stances and do whatever seems expedient at the time. Can we envisage any circumstances in which US commercial interests or the defence of the United States against, say, the Soviet Union would lead Americans to deem a forced union with Canada expedient? Would the elimination of a growing trade deficit with Canada be a sufficient motive for insisting on a common North American currency? Would security of resources, such as assured access to Canada's massive oil sands, be a contributing factor? Would a Canadian unwillingness to sell water to the United States stimulate that country to threaten abrogation of a free-trade treaty and thus cause Canadians to think political union a less painful alternative?

This kind of question is not easy to answer. We know, of course, that any action taken in the United States would be the subject of much public debate (as well as much behind-closed-doors lobbying). We know, too, that many in the United States would probably favour extracting such economic or military defence benefits from Canada as desired, without having to take on the long-run governing of or social responsibility for the Canadian populace and without having to accept unrestricted immigration of Canadians. But what would matter in the end would be how best the long-run interests of the American union might be served.

We have to remember that the United States is home to an intense, sometimes jingoistic nationalism that is cultivated in the news media, in the school system, and in the economic, social, and political realms. It is not something that ended with the annexation of Hawaii and other properties in 1898 and 1899. Consider one small example of fairly recent vintage. After the *Manhattan* navigated the Northwest Passage with the help of Canadian icebreakers, a book was published in the United States on this voyage. The publishing summary states:

> But not until man reached the moon did his earthbound contemporaries sail through the ice-choked Northwest Passage and bring to reality the dream of trans-polar commercial shipping.

The fact that the RCMP ship, *St. Roch*, had navigated this route decades before was allotted the grand amount of four lines at the close of the volume, and the dates given for its voyage were wrong. No more than half a line was allotted to the Norwegian ship that preceded the *St. Roch*. (Crean 1976, 232-3)[5]

CANADIAN ALTERNATIVES

Can Canada have bilateral free trade with the United States yet avoid eventual political union? Possibly. Our greatest strength would come from making our own federalism work. The provincial and federal governments' working together, settling differences amicably after careful and honest negotiation – as seems now to be happening – can go a long way towards preserving Canada's independence.

The news media have to be part of this process. Rather than simply emphasizing federal/provincial differences, as so often seems to be the case, they have to take on a greater responsibility for emphasizing points of agreement, too.

Second, we have to give more than lip service to diversifying our export markets. A few companies are doing this now, but many more have to become involved in the process.

Third, we need to go into any freer-trade negotiations with fairly modest expectations. Certainly we should be able to increase our productivity in many areas. But we should not assume that BFT would remove unemployment per se or make us a lot richer. It is more amatter of economic survival – a way of preventing things from becoming worse, rather than a means to great new riches. If we do not expect too much to begin with, we will not be as likely to be disillusioned with the results.

Fourth, our industries might have a greater chance of survival if we were able to have included in a free-trade agreement a provision for Canada to remove trade protections more slowly than the United States. An alternative arrangement, although one not as favourable to Canada, would be a longer period of protection for our weaker industries than for our stronger ones. This would be something like having a sectoral free-trade agreement on strong industries that was eventually extended to weaker industries. (For details, see Wilkinson 1985a).

Fifth, we might be less likely to be subject to US pressures for union if we attempt to co-operate with the Americans in an atmosphere of mutual respect and integrity than if we create an antagonistic environment for discussions. This does not, of course, mean giving them their own way on everything; it does mean doing our homework well so that they understand our position and the reason for it.

Whether these kinds of measures would be sufficient for Canada to preserve its political sovereignty under BFT is difficult to say. If the weight of opinion is that they are, then we might move cautiously ahead with negotiation of a BFT agreement. If, however, it is deemed that they are not, then we might be wise to work patiently for new multilateral negotiations under the auspices and umbrella of the General Agreement on Tariffs and Trade. But the development of this latter possibility requires a paper unto itself (Wilkinson 1985b).

NOTES

1 One Canadian economist has suggested that Canada should negotiate with the United States a penalty clause to come into effect if either nation abrogates. This penalty, he proposed, might be 1 per cent of the abrogating nation's GNP. When I tried this idea out on a cross-section of American academics, all that I received was widespread laughter and disbelief at the naïvety of Canadian expectations about what the United States might be prepared to commit itself to.

2 Luxembourg was the only state that had been a member of the Zollverein that did not become part of Germany.

3 The same US bill imposed new duties on imports of other Hawaiian goods hitherto tariff-free under the reciprocity agreement.

Whether this was by accident or intent is not clear, but a few months later the bill was amended to exclude Hawaii from the McKinley tariffs in accord with the original treaty.

4 The former President Cleveland has been quoted as saying 'Hawaii is ours.... as I contemplate the means used to complete the outrage, I am ashamed of the whole affair' (Mellon 1958, 343).

5 Another example of the United States' nationalism is its rejection of Canadian claims of sovereignty over the Arctic Islands as a US ship navigates through this area.

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The case for free trade with the United States

John Crispo

Free trade is by far the most realistic and sensible option for Canada in terms of its trading relations with the United States.

Although the issue of free trade has long aroused spirited national debate, much of the ongoing discussion has been confusing and misleading. The reason lies in the use of vague and inaccurate terms by most of the debators. It is essential, therefore, to be precise about what one means by free trade in order to ensure intelligent discussion.

That can best be accomplished by briefly reviewing the major trading options conceivably available to Canada vis-à-vis the United States. This summary is followed by a review of Canada's wider trading alternatives and then by an assessment of the risks associated with a free-trade arrangement with the United States.

CLARIFYING THE CANADA/US OPTIONS

What is involved in looking at Canada's options vis-à-vis the United States is, of course, more than a matter of terminology. There are significant differences among the varying degrees of Canada's potential economic integration with the United States, which could include a common market, a customs union or a free trade relationship.

Ultimately, one can conceive of a common market between the two countries similar to what the European Economic Community (EEC) is still supposed to become. Such an affiliation would presumably lead to more mutual undertakings than most Canadians – including this

Professor Crispo is a member of the Faculty of Management Studies, University of Toronto.

writer – are prepared to contemplate at this stage. Besides entailing the free movement of goods and services – not to mention labour – across the border between the two countries, a successful common market might eventually lead to a common currency and a similar approach to the regulation, subsidization, tariff protection, and taxation of industry. Once the two countries had reached such an advanced stage of integration, some would argue, political union would be the logical outcome. Yet such a fusion was intended by some founders of the EEC, where hopes for a United States of Europe are far from being realized.

Short of a full common market, there could be a customs union between Canada and the United States. Such an arrangement would require, in addition to the free movement of goods and services between the countries, a joint commitment to apply identical tariff and nontariff barriers in relation to other nations. Although a customs union would have the advantage of eliminating all customs barriers at the Canadian/US border – even for foreign products moving between the two countries – most Canadians would undoubtedly be leery about going that far until some lower level of involvement had proved itself. Others would simply prefer to preserve Canada's right to maintain its own tariff and nontariff barriers against non-American products.

Other than the maintenance of the status quo – an alternative discussed later – the only remaining Canadian/American option worth discussing is free trade – either on a sectoral or a general basis. Although Canada and the United States have been exploring sectoral free trade (more arrangements similar to those that prevail in agricultural implements), it does not appear to be a productive direction in which to move. Aside from the fact that any new sectoral free-trade agreements would require approval under the General Agreement on Tariffs and Trade (GATT), it would be difficult to put together a collection of such arrangements which would prove mutually beneficial. Each country has its list of preferences for sectoral free trade. These would have to be traded off against each other, which would not prove an easy task under the best of circumstances.

Comprehensive free trade makes more sense. In the first place, such an arrangement would not require GATT approval if it covered a substantial share of the trade between Canada and the United States. Equally important, it would avoid the complex trading-off process of sectoral arrangements. Instead, both countries would take their chances on a general free-trade agreement and proceed on that straightforward basis.

Yet as easy and satisfying as it may sound, such an agreement could undermine a number of culturally sensitive industries, such as broadcasting and publishing, and pose problems in sectors already subject to special trading arrangements between the two countries. Such concerns suggest the need for a general free-trade agreement with a few exceptions (though as few as possible). Canadian misgivings about the preservation of the country's cultural heritage would doubtless have to be provided special consideration. Existing production-sharing arrangements in the auto industry and in defence procurement might well have to be exempted. Agriculture might also require special attention, at least until Canada and the United States achieved some standardization of their support systems for various farm commodities.

CANADA'S TRADING ALTERNATIVES

A bilateral free-trade agreement with the United States is not Canada's only trading option. Its appeal and logic, however, become even more apparent as alternatives are reviewed.

At one end of the trade-option spectrum is the 'Fortress Canada' philosophy, which even the most narrow-minded and parochial of nationalists no longer espouse. Anything resembling a totally inward-looking national industrial strategy is inconsistent with Canada's economic history and would be suicidal in its inevitable impact upon the nation's future standard of living. To put it bluntly, Canada makes no sense as a separate economic entity. A market of fewer than 25 million people is simply too small to support a modern industrial society, given the scale and volume required by today's technology. Yet mad as the Fortress Canada mentality has become, some degree of it is implicit in the arguments put forward by various protectionists, especially some in Ontario. By calling for caution on the free-trade front, former premier Frank Miller is speaking from the era when Ontario industry could expect to survive merely by serving a protected Canadian market. Those days are long gone, and the sooner Central Canadian politicians realize it the better.

Almost at the other end of the trade spectrum is former Prime Minister Pierre Trudeau's 'third option', which would have Canada trade more with Western Europe and the Pacific Rim in order to reduce the country's dependence on the United States. The third option was in trouble even before the Canadian dollar began depreciating against the American while appreciating in relation to virtually all other currencies. The natural pull of trade in Canada has always been north-south, not east-west. Although the National Policy was able to circumvent this natural pull within North America, it could hardly extend Canada's trade reach beyond the Atlantic and Pacific, as east and west as they may be. The fact is that the two oceans present formidable barriers to trade, while goods and services can flow easily between Canada and the United States. Moreover, Canada's trade with countries other than the United States is often hampered by differences in attitudes, customs, laws, and languages. Indeed, although Canada should promote trade in every direction, it should recognize where its comparative advantage lies.

Basically the same admonition applies to considering trading arrangements that are even more multinational than those implied by Trudeau's third option. What immediately comes to mind, of course, is the GATT, which Canada has always supported and obviously should continue to support. But as long as the world is in the midst of a race between protectionism and recovery, Canada would be most unwise to rely on the GATT alone to ensure its access to the United States or any other market. One need only note that although the GATT has proven to be of considerable worth in alleviating tariff barriers to international trade, it has yet to have such an effect on the even more vexing nontariff barriers.

Still another trade option is maintenance of the status quo, however one may choose to describe it. After all, some assert, most tariffs between Canada and the United States are due to disappear or fall under the GATT to about 5 per cent by 1987. Thus, it can be claimed, superficially at least, that Canadian producers will then have virtually tariff-free access to the American market.

Aside from the fact that some American tariff rates will remain significantly higher than 5 per cent after the 1987 GATT reductions, it has to be emphasized that tariffs are no longer the major barrier to trade between Canada and the United States. Rather, the problem is the growth of nontariff barriers, such as buy-American policies and import quotas, to cite only two examples. Because of the existence of such trade obstacles, those who advocate maintenance of the status quo are really advocating a do-nothing policy that could leave Canada without ready, reliable entry to its most valuable market.

For Canada to continue to exist as a wealthy industrial society, it must gain secure access to America's large and wealthy market. Canada has no other natural market of more than 100 million consumers – the number that informed observers believe is the minimum market required for full exploitation of today's and tomorrow's technology. If Canada fails to secure ready access to the US market, the nation risks losing both its current standard of living and prospects for a better one in the future.

THE RISKS ASSOCIATED WITH FREE TRADE

It would be foolish to suggest that there are no risks – administrative, economic, cultural and political – involved in the US free-trade option. They have to be assessed and weighed before one can come down strongly on one side of the issue or the other.

Risks in perspective

The first risk relates to Canada's ability to negotiate a meaningful free-trade agreement with the United States. Although there will be some American opposition to such an agreement, all the current indications point to a positive reaction from the White House and the Congress if Canada gets its act together and puts forward a reasonable proposal. More difficult to assess is the constitutional ability of the two federal governments to eliminate nontariff barriers erected by the provinces and states. Both Canada and the United States are riddled with internal balkanizing forces that will have to be tackled if any sort of effective free trade is to be realized. The American government is, however, likely to have less difficulty with such challenges than the Canadian because of the propensity of the US Supreme Court to draw on the commerce and treaty-making powers of Washington to strengthen its hand in jurisdictional disputes with the state governments.

Admittedly, there is also the risk that the United States might choose at some point to abrogate a free-trade agreement with Canada. But assuming that an agreement would work to both countries' advantages, it is difficult to comprehend why such arbitrary action would be taken. Nonetheless, if it was taken – for whatever reason – the impact would be far more traumatic for Canada, since the junior partner in such ventures invariably has to make more accommodations and, therefore, finds it more difficult to disengage itself in the event of a rupture.

The risk of rupture is not to be minimized, according to those Canadian nationalists whose conspiratorial view of the United States lead them to imagine all manner of scenarios in which that country plays its superior free-trade hand to blackmail Canada into selling off its energy or water at bargain-basement prices or entering into a heinous mutual defence system or any number of other disturbing possibilities. Assuming the true nature of the United States is this diabolical, it is unlikely that Canada could resist any such determined overtures – even if it stayed out of any free-trade arrangement. Moreover, Canada enjoys such good will in the United States and America would suffer so much international bad will if it did try to blackmail Canada that the prospect is not one for realistic concern. Even so, it might be worth exploring the possibility of a lengthy notice period or even high penalties in the event of either country's calling for abrogation of any free-trade commitment.

From a practical point of view, the biggest Canadian problem could be the distribution of the benefits and costs associated with free trade. Anything like a comprehensive free-trade agreement with the United States would obviously result in some winners and some losers, both industrially and individually. Most of those who have studied the matter closely are convinced that the winners would be bigger and more numerous because free trade would eventually bring about a general rise in the country's standard of living. In the meantime, however, adjustment assistance of various kinds would have to be made available to the losers through retraining, upgrading, relocation, income-maintenance, and related programs. Thus, any free-trade agreement would have to be phased in to provide adequate time for transitional measures on both sides of the border, but especially in Canada, where the accommodations would likely prove more difficult.

Lest the thought of losers and adjustment assistance dissuade anyone from supporting a free-trade arrangement, let me emphasize that the agreement would at least ensure that there would be winners as well as losers (and, therefore, the resources to take care of the latter). In the absence of such an agreement, there is a real risk that there would be mainly losers, with little or no additional means to assist them.

Another criticism of free trade with the United States is linked to the long-standing concern about branch-plant management in Canada. This argument confuses cause and effect. Branch plants originally developed in Canada because of the National Policy, which encouraged American and other foreign-based firms to serve the protected Canadian market by establishing plants here. Lately, because of US tariff and nontariff barriers, successful Canadian firms have been forced to resort to the same tactic – only in reverse – to serve their American customers. Free trade would put an end to these uneconomic locational inducements and allow the principle of comparative advantage to assert itself. If nothing else, it would tend to eliminate the branch-plant phenomenon on both sides of the border, except where natural economic considerations dictated its continuance.

Currently, there is concern in Canada over the flow of Canadian investment funds into the United States. Much of this capital transfer is caused by successful Canadian firms' ensuring access to the protected American market by locating major production facilities there. If free trade existed between the two countries, that incentive would disappear. Canadian-based firms could then serve the entire North American market from Canada, if this country's comparative production advantages paid them to do so.

A major worry about any free-trade agreement with the United States results from the increased economic interdependence that would flow from it. An inescapable byproduct of any such deal is that Canada would lose some of its economic independence. The critical questions are: how much economic independence does Canada now enjoy and how much does it stand to lose with free trade? The nation's dependence on trade with the United States has risen from roughly 60 to 75 per cent during the past decade. On the export side, Canada's growing dependence on the US market has been substantially increased by the Auto Pact. Under it, Canada is already extremely vulnerable to a reversal of American attitudes. Whether we like it or not, Canada cannot escape a high degree of economic interdependence with the United States. This situation would undoubtedly increase under a free-trade arrangement, but the magnitude of the change should not be exaggerated. Neither should one minimize the way in which free trade would reduce Canada's economic dependence on the United States in the sense of our not having to lobby Washington every time a protectionist group in some industry threatens to persuade the US administration to introduce measures contrary to Canada's interests.

Another major concern is that closer economic ties with the United States would jeopardize Canada's cultural identity. Obviously, less fear is usually expressed in relation to French Canadian culture than English Canadian. It is difficult to imagine that English Canadian culture could be more saturated by American influences than it already has been. Yet it may be necessary to write into any free-trade treaty special measures to protect some Canadian cultural endeavours. Concerns about cultural assimilation may be lessened if Mexican Americans and other US minority groups continue the current trend of resisting the melting-pot process. If the United States becomes less homogeneous culturally, its mass culture could prove less threatening to Canadian culture – English and French.

It is more difficult to deal with the potential loss of Canada's political sovereignty – if not its very existence as a separate national entity – if the country becomes increasingly dependent on the United States economically. There is no denying that these fundamental risks exist when a relatively small country enters into anything as economically integrated as a free-trade area with a much larger neighbour. However, it is easy to exaggerate these risks. Moreover, it is possible to argue that they could prove more dangerous in the absence of a free-trade arrangement than with one.

It is useful to explore the worst-fear case – that Canada could disappear as a separate sovereign country if it becomes too economically dependent on the United States. Such a dismissal prospect depends on one of two propositions, neither of which necessarily follows from the premise. One is that Canadians would voluntarily relinquish their status as Canadians in order to become Americans, something I argue that they would be inclined to do only if they saw the disparity between the American and Canadian standards of living widening. Assuming Canadians would not otherwise freely choose to become Americans, the worst-fear case depends upon the United States' taking over Canada by brute economic and/or physical force. The fact that it has not done so already appears to carry no weight with the anti-American element that comprises the bulk of the nationalist contingent in this country.

If Canada is ever absorbed by the United States, it is much less likely to be by American design than by Canadian default. Canadians are a proud people. They could probably increase their standard of living by an average 10 to 15 per cent by joining the United States. Obviously, most Canadians believe that being Canadian is worth that difference. But what if the figure should widen to 20 or 25 per cent? At what point would Canadians begin to think that the difference had become so great they would rather join the United States?

The greatest risk

If Canada does not work out a meaningful economic agreement with the United States, it is running a serious risk that overrides all the others. Without such an agreement, there is a real chance that the US standard of living will rise considerably faster than the Canadian. If anything will destroy this country, it is that distinct possibility. At some point, the hard-pressed East or the hard-done-by West could become so fed up with the selfish and shortsighted domination of Canadian trade policy by the Ottawa/Queen's Park axis that they will put up with it no longer. Under certain circumstances, it is conceivable that either or both regions would abandon Canada for the United States.

Ironically, it is the nationalists who could destroy this country. Standing in the way of an economic accord with the United States could have precisely that effect. Some nationalists are so misguided that they do not seem to comprehend the potential consequences of their actions. Unfortunately, the majority are anything but naïve in this respect. Among this group are those with an ideological or political agenda favouring a less market-oriented society, a goal that would become more difficult to attain if Canada were party to a free-trade agreement with the United States. Even more numerous, one suspects, are the Canadian producers who could not survive the competition of a North American market. To compensate for their lack of competitiveness, they wrap their narrow, vested economic interests in a Canadian flag, thereby commanding not only a great deal of attention but also a considerable amount of protection for their own interests. One can only hope that governments and politicians in Canada will realize that what is in the selfish, short-run interests of these anti-American pseudonationalists is anything but in the interests of the country.

CONCLUSION

There is no risk-free trading option for Canada, but the only one that makes any real sense for the long run is free trade with the United States. The way to achieve that objective is to negotiate a trade-enhancement treaty between the two countries as quickly as possible. It should commit Canada and the United States to the principle of free trade and set forth a procedure and timetable for working in that direction. Speed is of the essence. Both federal governments are enjoying a mutual window of opportunity that may not stay open for very long. Brian Mulroney and Ronald Reagan have said the right things about closer economic ties between Canada and the United States. They should translate their words into action before it is too late.

The peaceable kingdom of free trade

Abraham Rotstein

The global trading system stands on the edge of disarray. At the risk of only slight exaggeration, one can say that more trade barriers have been erected in the last four years than were dismantled in the previous forty during the meticulous trade negotiations of the postwar period. While tariffs have been brought down to low or even negligible levels, ingenious administrative devices and nontariff barriers have rapidly taken their place.

These dynamics of world trade should not be seen in isolation. They are symptomatic of the larger difficulties of the world economy: high interest rates, the level of the American dollar, the international debt structure, and the pace of technological change, to name only a few.

We can do little more here than list some of these larger problems. But they help to explain the climate and the rhetoric that is being invoked at the present time. As the situation becomes cloudier and the future more uncertain, the rhetoric becomes more pristine as we cling desperately to the credos of the past.

The free-trade camp is parading once again the sterling ideals of a global division of labour – a realm of reason, orderly accommodation, and benign providence. But every vision of Olympus is reinforced by a vision of Hades. Protectionists are admonished with scenarios from the 1930s: an economic Armageddon awaits us if we deviate from the true church founded by David Ricardo.

Canada, we are told, should stand up and be counted on the side of virtue. It is incumbent on us to play our part in holding the protec-

Mr Rotstein is a professor of economics at the University of Toronto.

tionist forces of darkness at bay. The just rewards of the law of comparative advantage – specialization and large markets – are dangled before us as the rationale for a free-trade agreement with the United States. By doing good we would also be doing well.

It will come as no surprise that I do not take the high-minded idealism of the free-trade camp at face value. I suspect that the current stampede towards free trade is motivated more by fear and a diffuse anxiety than by a heroic espousal of liberal principles. This compulsive search for an American safe haven is, in my view, indicative of a hidden apprehension that this cherished liberal trading world may not hold together and that we had better make a run for it. But run where? There is some divergence of view as to which is the frying pan and which is the fire.

The double talk about maintaining our obligations to the General Agreement on Tariffs and Trade and to all our trading partners while simultaneously digging into Fortress North America is, I think, self-deluding at best. From a political point of view, such a free-trade agreement would certainly not be taken in Europe and in Japan as an even-handed multilateral gesture. We cannot have it both ways. I am reminded of the famous line of the québécois comedian Yvon Deschamps. At the height of the separatist crisis, he extolled the virtues of 'un Québec libre dans un Canada fort et indépendant'.

Many anomalies, contradictions, and uncertainties await us. There is no 'safe' policy in attempting to maintain the status quo, nor is there one in a free-trade treaty with the United States. Trade policy today is a matter of intuitive judgement of many imponderables. In simpler language, some might say that it is a crap shoot.

The dilemma of Canadian manufacturing

One serious difficulty can serve as an illustration of several others that I will touch on later. Many Canadian manufacturers who export to the United States feel vulnerable to impending US trade restrictions. They support a free-trade arrangement as a way of getting some protection from the further extension of American nontariff barriers. But they sense intuitively that this is at best an uncertain proposition: a free-trade arrangement may not happen, it may take a very long time if it does happen, and it may not afford the secure protection for their exports that they would like. The only fully secure solution, they feel, is to shift their manufacturing operations to the

United States. If we don't have free trade, therefore, it is clear that we will see the departure of some Canadian manufacturing southwards to a safer haven.

The American subsidiaries in this country are a different story. Many of them are here expressly to serve the Canadian market. But if there is free and unimpeded access to that market from their main manufacturing plants in the United States, they will have little reason to maintain their Canadian operations and certainly no reason to expand them. I am not suggesting that there will be a precipitate exit from this country. There are sunk costs. Some subsidiaries may even stay because they feel that they will have a more secure edge in the Canadian market if they have a Canadian presence. But we may expect an important segment of our US subsidiaries either to close up shop entirely or to scale down their operations to sales and distribution networks. Warehousing will replace manufacturing.

The dilemma is clear cut: whether we do or we don't enter a free-trade arrangement, the result will be long-term attrition of Canadian manufacturing. Add to this the much wider threat that is posed by the general shift of manufacturing processes to the low-wage and high-productivity countries of Asia. The Americans are far ahead of us in starting joint ventures and establishing plants in Japan, South Korea, Malaysia, and the Philippines. The pressures that this shift will eventually exert on US manufacturing employment will no doubt spill over into Canada.

Our present impasse on maintaining quotas on the import of foreign cars is a case in point. It is not clear that Canada will be able to continue its present quota arrangements with foreign car companies if the Americans are dropping them. Moreover, the Auto Pact may not be cancelled directly, but it may fade out. It is not generally known that the Auto Pact includes a provision that permits the big three American automobile manufacturers to pay the Canadian duty on imported cars as an alternative to meeting their production quotas in this country. Under a free-trade arrangement, there would, of course, be no import duties on American cars, unless we provided for a special exemption. With or without free trade, the attrition of employment in our most significant manufacturing industry, automobiles, will soon be felt.

An even larger issue that looms is the race between the United States and Japan to capture the high ground in the new technology.

The winner of this race will secure the key to new manufacturing. If perchance the United States loses, what we would be sharing with the Americans are the miseries of industrial attrition rather than the benefits of a continental division of labour.

The forgotten questions

These are only a few of the uncertainties that plague the present debate about the advisability of a free-trade treaty with the United States. Once we are locked into such a treaty, we will have to live with whatever problems ensue. The treaty itself, moreover, is bound to constrict significantly our freedom of action in adjusting to these problems.

It may be that the simple theoretical beauty of the free-trade ideal has mesmerized us and obscures all these difficult realities. We have failed to ask some of the elementary questions associated with such a policy:

- How would we actually go about securing a free-trade agreement?
- What would we have to give up in order to get it?
- Is the premium worth the insurance, and is the insurance reliable?

These are the questions that now need to be addressed.

SECURING A FREE-TRADE AGREEMENT

It appears that Canada's trade dilemma with the United States resembles a poker game more than the homespun truths of the economics textbook. Gone are the old, reliable standbys about the beneficence of trade that will cover the globe like the dew, bringing economic blessings to all mankind.

Many parties are seated at the American poker table holding different hands and different chips. First we have the administration – the US trade representative and the president. Then there is the Congress, up for election in eighteen months. Also playing for big stakes are the massive foreign-trade lobbies, particularly the Japanese. The modest Canadian player at this table has a great deal at stake but must try to fix simultanously on all these other players before he can see his way clearly to making his own move.

On the table as well are a forest of crystal balls proclaiming their diverse verdicts on the fate of the American dollar, American interest rates, and the rocky road ahead for the American economy. Even the likes of Machiavelli would be hard put to survive in this game of bluff, bluster, double dealing, and double vision.

To start with the appraisal of our present situation, it is generally agreed that the United States is on the verge of some massive protectionist measures, aimed mainly at Asian and European imports, to deal with its $120 billion trade deficit. Canada, by far its largest and presumably least threatening trading partner, will get caught in the undertow. The argument is made that we must move quickly before the next congressional elections produce a spate of protectionist legislation. The Reagan adminstration is apparently willing to consider some special arrangement, such as free trade, and we have, as the saying goes, the brief window of opportunity open before us. Let us therefore take the plunge! So runs the conventional wisdom of the free-trade position at the present time.

I seem to recall that the last time I heard these metaphors invoked – the window of opportunity and taking the plunge – was on Wall Street in 1929. I don't wish to sound unduly alarmist, but I believe that this self-generated panic in free-trade circles is short-sighted and may be harmful over the long term.

As a start, let us look at time horizons. Although it is true that the American election looms, it is also true that comprehensive trade agreements of the kind we are contemplating have never been negotiated within the one-year period that is being suggested. Anyone who pretends that we can produce an agreement within that time is either fraudulent or foolhardy. There is an immense range of products and industries to be covered, safeguards, exceptions and special circumstances to be agreed upon, and most of all, the American states and the Canadian provinces to be consulted, placated, and reconciled. Five years would be far more reasonable than the artificial 'window' we are presently considering.

Second, since we are no longer negotiating tariffs but rather nontariff barriers, we are neccesarily contemplating a treaty that is intended to override both 'buy American' legislation in the United States and 'buy provincial' legislation and practice in Canada. To put it bluntly, such a blanket legal measure is totally unprecedented, and we are treading *terra incognita*. We do not know what form such an overriding treaty should take or how long such complex negotiations would have to continue.

There are bigger hurdles yet to overcome before we enter the peaceable kingdom of free trade. The benefits are vouchsafed in theory – but what are they likely to be in reality? The previous Canadian government issued its *Trade Policy for the 1980s* as a wish list without a shred of analysis of what the concrete benefits or costs were likely to be. Are we any wiser since that time? What if there are few benefits to be realized? For the conventional trade theorist and for the inveterate optimist, this situation is virtually inconceivable – but only because their analysis is based on a presumption of some measure of economic growth and industrial expansion in the American economy. Over the long term, the great unknown that overhangs this issue is the American rivalry with Japan for global industrial hegemony. I do not wish to add yet another prediction to all the loose ones that have already been made. But it is at least conceivable that the Americans will lose this race. What does trade theory tell us about the partitioning of *costs* at a time of industrial attrition?

The question, however, is not whether we are optimistic or pessimistic about American prospects. The real question is whether we should be forced to make a choice at the present time, rather than later when the picture is clearer. It is doubtless true that our economic fate is already, and will continue to be, closely tied to that of the American economy. But keeping in mind the extensive integration that will come into play by 1987 after the Tokyo Round measures are implemented, do we now want to draw the strings tighter still?

Industrial policies as 'subsidies'

The most important consideration to my mind has hardly received adequate discussion. I refer neither to the industries that would go under in Canada nor to the unemployment that would pile on top of the existing base rate of 10 per cent. I want to explore the freedom of action in economic policy that would have to be relinquished under a free-trade agreement.

Let me explain this further. What animates the current American discussion on proposed protectionist policies is the sense of grievance against all those many countries that are presumably subsidizing their exports to the United States. This competition, from which the Americans are hurting badly, is deemed 'unfair'. Americans perceive it to be unfair not because the American dollar is high but because foreign governments are secretly or openly subsidizing their domestic industries. Hence the popular phrase in Washington this season is the 'level playing field'. (Last season, we may recall, it was 'don't shoot yourself in the foot'.) The 'level playing field' sums up the American complaints and also indicates the ground rules they expect to set in place.

If the Americans are to agree to a long-term free-trade agreement, they will require certain safeguards and conditions that apply to both sides. There is no doubt that the investment restrictions that are still embodied in Investment Canada – say, for cultural industries – will go by the board. But so will all other measures that can be construed as providing 'unfair' subsidies to our exports. This covers a lot of territory.

Let us begin by considering regional development programs under the Department of Regional Industrial Expansion. The Industrial and Regional Development Program, the basic program for regional development, will cost $344 million this year. Further, it is estimated that Canadian business firms receive an annual total of about $4.5 billion in grants and special contributions. All such policies of regional stimulation or industrial assistance could be deemed government subsidies. The case of Michelin Tire a few years ago is one illustration. Recently, Sinclair Stevens initially declined to offer a grant to the Domtar plant in Quebec precisely for this reason. The Americans could regard it as an unfair subsidy and thus would have a pretext for slapping on countervailing duties at a later date.

If we contemplate the programs we have – the industrial assistance programs, the grants to Crown corporations, the dozens of other such programs – we realize that what is in jeopardy is the entire structure of our present and future industrial policy. The only real option would be to conform to the existing American practices – as Sinclair Stevens has done in the Domtar case. These are the only practices that could not be tagged later as 'subsidies'.

Import, and production quotas

There are other jokers in the pack. One of the measures that both we and the Americans have been using to moderate the erosion of the automobile industry under the pressure of cheaper Japanese cars has been a 'voluntary' quota system. It now appears that the Americans are prepared to abandon this system. General Motors, for example, has established extensive joint-venture manufacturing facilities in Japan and in South Korea and is now able to import some of its 'Chevrolets' into the United States rather than make them in Detroit. But it is not clear that this is the route we wish to follow in Canada – at least not at the present time.

But suppose that a free-trade agreement were actually in place. Would we still have such a choice open to us? Would we be able to continue the Auto Pact at all (without a special exemption)? With its built-in production guarantees, the Auto Pact certainly contravenes what is meant by free trade. The Americans have, in any case, let it be known that we cannot expect the Auto Pact arrangement to be repeated – that is, we cannot expect any further industrial agreements to have built-in production or employment guarantees.

Voluntary quotas on imports are one important measure that we may have to abandon, and closely related to it are production quotas. We have had some very modest success in convincing the Japanese to establish production facilities in this country if they expect to continue long-term sales of automobiles here. We may wish to resort increasingly to such policies to stem the haemorrhage of manufacturing employment to the low-wage, high-productivity countries of Asia. But should we contemplate applying these measures to American multinationals, which may have quite ambitious relocation plans (as evidenced by General Motors), our hands would be tied. Voluntary quotas and mandatory production requirements are certainly not part of the 'level playing field'. The only exceptions would be those that conform to American policies towards third countries.

Exchange rates and tax rates

The same can be said of exchange-rate policy. The one saving grace in the otherwise dismal Canadian economic picture is our export performance in the United States. If this were to falter, we might certainly consider, for example, allowing our exchange rate to drift lower. But doing so could easily be regarded by the Americans as unfair competition, and some agreed restriction on our exchange-rate manœuvres would very likely be one of the conditions of the projected treaty.

Finally in this package of economic-policy restrictions is the question of tax rates. Not only would the general level of tax rates have to approximate American rates (this is called 'harmonization'), but differentiated rates for certain firms or industries would be open to objection by the Americans as hidden subsidies. (We offer a total of about $7.7 billion in tax breaks in Canada.)

The restriction of fiscal and industrial policy

The free traders insist staunchly that our sovereignty would not be compromised under a free-trade agreement – that such an outcome is a myth in the minds of misguided nationalists. But examine the list of restrictions just enumerated that are likely to be part of the free-trade framework: no industrial policies that could be construed as subsidies, no voluntary import or production quotas that threaten the interests of American firms, no exchange-rate manipulations, and no significant tax-rate deviations. These would present severe restrictions on our fiscal and industrial policy. Add the lockstep monetary policy that we have pursued and continue to pursue in tandem with the United States over the past few years. The picture is clear. There is little need to debate issues such as loss of sovereignty in the abstract when we would have compromised our freedom of action on these major levers of economic policy.

THE UNCERTAINTY OF BENEFITS

Free trade arrived at by treaty, is likely to drag in its wake a lengthy series of restrictions, only some of which have been mentioned here. As the pressures of industrial readjustment grow and as the burden of unemployment rises from its initial base of 10 per cent, we seem bent on tying our own hands by drastically limiting our freedom to respond. To paraphrase the old adage of Henry Ford, give them any economic policy they want as long as it's American policy. This is the premium we would likely have to pay to acquire the trade insurance that we seem to crave.

But is the insurance policy itself a reliable one? Once we paid the premium, could we count on total, unimpeded access for Canadian goods to the US market? We already hear talk of achieving, say, 50-per-cent relief from the application of American nontariff barriers. It is not clear what such a statement means or where the bottom line lies in providing exemption from nontariff barriers. As long as Canada and the United States remain constitutionally separate countries, each must reserve for itself certain basic powers in supervising the entry of foreign goods. Chief among these are the powers to prevent dumping, to check the valuation of imports, and to set product standards.

Under a free trade agreement, these powers would become especially important since each country would become a very convenient place in which to unload excess stocks of goods that could not conveniently be disposed of elsewhere. The potential for intermittent disruption of certain industries in the receiving country would be very great, and no government could afford to relinquish its powers to intervene in these instances, regardless of a free-trade treaty.

These and similar reserve powers would have the potential, in times of stress, to become the thin edge of the wedge. They could serve as the loophole through which domestic political pressures could be accommodated. Given the division of political powers in the United States and the responsiveness of the American Congress to local industrial dislocation, the guarantees afforded by any free-trade treaty would have to be regarded as qualified. Even the extent of this qualification is elastic; it might depend, for example, on the size of the US trade deficit.

It appears, therefore, that the premium we would have to pay is fixed and certain in regard to the economic powers that we would have to give up. But the value of the insurance we would acquire is elastic; it would expand and contract with economic and political conditions in the United States.

Provincial agreement

I have mentioned only briefly the corresponding problem on the Canadian side. The fracturing of the Canadian common market, as we refer to it these days, is a well-known phenomenon that lurks on the fringes of every agenda for national economic recovery. But we are very far from a serious solution to this problem. To speak of a free-trade treaty with the United States presumes, in effect, that this problem will be resolved in rather short order. But what do we know of the true intentions, of say, Quebec, Ontario, New Brunswick, or British Columbia? Would each be willing to give up its subtle and not so subtle discriminatory policies that favour local suppliers? Some of these provinces have pockets of particularly high unemployment and might not be easily amenable to abandoning local protective measures, particularly if they did not stand to gain a great deal from a free-trade treaty. But the federal government would have to offer the

Americans an across-the-board assurance of compliance by the provinces before such a treaty could take effect.

CONCLUSION

By listing some of these difficulties, I hope to pull down to earth some of our more passionate and idealistic free traders. If they choose to intone yet again that we need access to that market of 220 million people, let me remind them that by the end of 1987 under the Tokyo Round agreement, 96 per cent of all Canadian industrial goods will enter the United States at a tariff of 5 per cent or less. Ninety-six-per-cent access is not no access. The problem of American nontariff barriers should not, in my view, be dealt with by exemption through a treaty. Rather, we should deal with these issues on a case-by-case basis and remind the Americans once again not only that we are their largest trading partner but that we can and will apply nontariff barriers of our own if that is the route they choose. In the homespun language of Washington, they should not shoot themselves in the foot.

What we might turn our attention to in the meantime is the scrutiny of the weaknesses in our own economy – the weaknesses in our research and development facilities, the obsolescence of our industrial structure, the low rates of productivity growth, the extraordinarily strong tendency to import manufactured goods, and the entrenched adversarial relations among business, labour, and government. Once the peaceable kingdom of free trade is revealed to be a mirage, we shall have to abandon the hope for a panacea and get down to the problems where they actually exist.

Discussion

RODRIGUE TREMBLAY (Université de Montréal): Mr. Rotstein's argument is that since Canada will have free access for 96 per cent of its manufactures into the US market by 1987, our economy is already geared for a large market and, therefore, open to blackmail and threats. Why then shouldn't we negotiate some kind of rules to protect our interests? Our hockey players play in the National Hockey

League, but they are not afraid of being unemployed overnight because there are rules that set the game.

ABRAHAM ROTSTEIN (University of Toronto): I think we have to be a bit more specific as to precisely what we are negotiating. What do the rules mean? In what context? Decided by whom? To deal with what kind of cases? On the table right now are two clear proposals. One is to attempt to digest a great deal of what is offered to us by the Tokyo Round of the GATT negotiations. The other specifically addresses the dilemma of nontariff barriers, which can only be answered by a treaty. Talking in general terms about 'rules' is a Dale Carnegie approach to the issue.

ED SAFARIAN (University of Toronto): Bruce Wilkinson has given us two examples of trading arrangements that led to much closer political integration. Now, comparisons are always interesting but there are, as I'm sure he knows, quite a few examples in which that did not happen. The Benelux economic union did not lead to political integration, the European Free Trade Association has not done so. The European Common Market, which is a much closer union than a free-trade area, has achieved a very limited degree of political integration. I could go on and on. And in some of these arrangements, the partners are very unequal. So it seems to me that he has not demonstrated his case by picking a couple of examples in which trade arrangements did lead to a process of political integration.

BRUCE WILKINSON (University of Alberta): The point is that there have been any number of statements made in Canada to the effect that a free-trade agreement has never led to political integration. The Senate report made that statement, Peyton Lyon made it in his book, and many other people have made it, too. I am saying that statement is wrong. I'm not saying that political integration will necessarily occur, but I am saying we should be aware that it has occurred.

Also, each of the cases you mentioned involved no very large dominant country. Even in the case of the Benelux countries, Belgium was already internally divided in language, culture, and so on. The situation of Canada and the United States is much more akin to that of the German Zollverein than it is to these others.

ED SAFARIAN: I have a related question for Abe Rotstein. I guess it's a question of how one defines what it is we are getting to, and that's a very difficult question. Northrop Frye has said that the problem with Canada is its search for identity, the question of where is 'here'. It gets even harder to answer the question if we're going from here to there and we haven't defined where we are.

The European Economic Community does offer a comparison. Although the EEC countries have much closer economic integration than what is envisaged for a Canada/US free-trade area, their industrial policies have not disappeared. All sorts of government aids to industry are in use, although the EEC sets broad limits on their overall size. Is something being proposed between Canada and the United States that doesn't exist in other free-trade areas or common markets?

ABRAHAM ROTSTEIN: I think that your question is very important, but I don't know that one can answer it in general or in theory. One has to proceed by the law of straws in the wind. What is the motive of the Reagan administration? What are the issues open for negotiation? Just as there is no free lunch, there is no free trade. Once things are on the table for negotiation, they become open questions. In the lumber dispute, we have had some indications that Canada and the United States have totally different approaches to the ownership of territory, as symbolized by the different ways of calculating stumpage charges. This is the kind of issue on which we will have to be prepared to compromise. The issue is really what is defined as a subsidy, and given the mood in Washington, I am not optimistic that we could get as even-handed terms as six countries were able to get in the European arrangement. When it comes to mediation and arbitration of disputes, I am not sure that the GATT agreement and the GATT court wouldn't be a lot safer than we would be one on one.

PETER LESLIE (Queen's University): Two questions to Abe Rotstein. Rodrigue Tremblay and others have reminded us of Canada's vulnerability to changes in American policy, given the proportion of our exports directed to the United States and the high percentage of them entering duty-free. Is the heart of your position that we should avoid a bilateral arrangement in which we do not have the protection of the GATT and other international agencies to police the agreement?

Second, if that is the essence of your position, are those international agencies sufficiently strong? Do they now give us the protection and the stability that we need to ensure continued access to the American market?

ABRAHAM ROTSTEIN: Professor Tremblay talked about insurance in case the Americans decide to go protectionist. I don't know what kind of insurance we're going to need because I don't know the extent of the Americans' intention to increase the use of nontariff barriers. I think we will have to take it case by case. We will probably have to keep on improving our lobbying and protection of our interests. Recall that the Japanese spend, at a rough estimate, ten to fifteen times as much on lobbying as we do. For the rest, I think we have to keep our options open.

On the question of the GATT, yes, I think we are safer in its council and mediations, where we may have potential allies, than we would be on a one-to-one basis. And I do not believe that we can simultaneously enter a free-trade treaty with the United States and keep all our GATT connections open. I am reminded of a line from the famous Quebec comedian Yvon Deschamps. At the height of the separatist crisis, he said in sterling tones that he was for 'un Québec libre dans un Canada fort et indépendant'.

PART V: THE MECHANICS OF NEGOTIATION

Bilateral trade liberalization with the United States and multilateral liberalization in the GATT: selected observations

Ronald Wonnacott

The bilateral and the multilateral approaches to trade liberalization are not in conflict. A number of successful rounds of multilateral negotiations – in particular, the Kennedy Round and the Tokyo Round – have taken place without being substantially disturbed by the existence of the European Economic Community or the formation of several free-trade areas. Although there has traditionally been concern that bilateral deals might weaken the political thrust towards multilateral liberalization, the recent view of the office of the United States' special trade representative has been that a US/Canada initiative would strengthen that thrust. (This is the 'bicycle theory' – if you don't keep moving, you fall off.) Such a bilateral initiative would also encourage third countries into stronger support of another multilateral round.

A bilateral Canada/US agreement with the GATT framework

Legally, there are no major obstacles to combining the bilateral and the multilateral approaches. From its beginning, the General Agreement on Tariffs and Trade has recognized free trade areas as valid exceptions to its basic philosophy of nondiscrimination. (In fact, this special provision was included because, at the time the GATT was being established, Canada and the United States were considering a free-trade area. Ironically, nothing came of that, and it was the Europeans who took advantage of the provision in forming the EEC.)

Professor Wonnacott is a member of the Department of Economics, University of Western Ontario.

Specifically, if Canada and the United States were now to negotiate an across-the-board free-trade agreement, they could invoke the 'interim agreement' procedure of Article 24 of the GATT. Under this procedure, the two countries would submit a plan and schedule for the creation of a free-trade area. Other GATT members would thus be informed and would be allowed to make recommendations. This is the procedure that other applicants have used in the past; in none of these cases have excluded countries made formal recommendations .

An alternative would be the 'declaratory procedure', under which two countries simply declare that a free-trade area between them already exists. The conservative estimate is that by 1987, when the Tokyo Round tariff cuts are complete, 80 per cent of Canada's exports to the United States will be duty free, as will 65 per cent of our imports from the United States. Although this situation will not be nearly as close to free trade as it is fashionable to believe (since any such calculations completely exclude trade that is blocked by prohibitive barriers), Canada and the United States will then be closer to free trade than other countries have been when they formed regional free-trade groups without objection in the GATT. Hence, Canada and the United States could be deemed to qualify under this clause.

The problem with the declaratory procedure is that other GATT members may view it as too facile for such important trading nations to invoke. Accordingly, these members might object to Canada/US liberalization of nontariff barriers, which is not covered by the declaratory procedure. (Such nontariff liberalization is essential, and it *is* covered by GATT's interim-agreement procedure.)

Although a bilateral Canada/US agreement would raise no legal problems with the GATT, it is not clear how distracting and politically difficult negotiating it might be if a multilateral round under the GATT were taking place simultaneously. This is why, if this initiative is to be taken, it should be taken without delay. Another reason for avoiding delay is that the US administration may lose its power to initiate and negotiate with the approach of the 1986 and especially the 1988 elections.

A comparison of bilateral and multilateral liberalization

A second important question is: how would a bilateral agreement compare economically with multilateral liberalization?

There seems little prospect of achieving anything approaching multilateral free trade and Canada has little influence on this issue anyway. Thus, even if we wanted it, we couldn't get it. This being said, it is still of interest to ask: if multilateral free trade *were* possible, how would the gains to Canada compare to those offered by bilateral free trade with the United States?

The traditional answer has been that multilateral free trade would provide greater net benefits because the gains from trade should increase as the number of our trading partners increased. Moreover, multilateral free trade would avoid an often-unrecognized cost that we would incur if we were to liberalize our trade with only one country or a few, rather than with them all. Technically, this is called the cost of trade diversion. In simple terms, it means that given a bilateral agreement with the Americans, Canadians would switch some import purchases from least-cost third countries (such as Japan) to the United States. We would be getting these goods from the United States at higher cost; the only reason we would be buying them there would be our free-trade arrangement, which would provide US producers with an advantage – a 'preference' – in the Canadian market over, for example, the Japanese . (In order to sell in Canada, the Japanese would still have to pay the Canadian tariff; the Americans would not.) With multilateral free trade, such preferences would not exist; therefore, there would be no such trade diversion with its concomitant costs.

Because of the lack of trade-diversion costs – plus the gains from liberalized trade with all countries, rather than just the United States – the traditional expectation has been that multilateral free trade would provide Canada with substantially greater benefits than a bilateral arrangement with the United States alone.

However, this view does not take into account several important advantages for Canada of a bilateral agreement that would not be available in a multilateral one. The first is that under a bilateral agreement, just as US producers would enjoy preference in the Canadian market, so too Canadian producers would enjoy preference in the *US* market. (For example, Canadian producers would no longer have to pay a tariff to get into the US market, but Japanese producers would.) This advantage could be so important to Canadian producers that, according to a recent study by David Cox and Rick Harris (forthcoming), it would more than offset the special advantages of a multilateral agreement described above. In other words, the best estimate is that Canada has more to gain economically from a bilateral free-trade agreement with the United States than from a multilateral agreement.

Another advantage of a bilateral agreement is based on the fact that tariffs are becoming less important than nontariff barriers, such as quotas and buy-American provisions in government purchases. In multilateral negotiations, we have limited influence over which of the myriad of nontariff barriers are dealt with. For example, during the next GATT round, the US nontariff barriers that will be on the agenda will be those that others, such as the Europeans and the Japanese, want to remove – not necessarily the ones that Canadians most want to remove. The advantage of a bilateral negotiation is that it would allow us to target the US nontariff barriers that hurt us most.

The overall picture

A note to keep all this in perspective. In the event of bilateral *or* multilateral trade liberalization, Canada would achieve large economic gains – estimated at 5 to 10 per cent of GNP, or, in 1984 dollars, about $20 to $40 billion per year – because we would be getting freer access to the United States, the world's richest market.

In fact, our gains would likely be substantially larger than these estimates for a reason that Canadian business has recently been recognizing and emphasizing: in an era of otherwise increasing protection, we would also be securing our present trade with the United States, on which such a large proportion of our GNP *now* depends. To see how damaging the losses leaving this trade at risk might be, consider two examples: (1) the current proposal in the United States to impose a three-year 20-per-cent phased-out import surcharge – a policy that has great appeal in the United States Congress because of the false promise it holds out of greatly reducing both the fiscal and the trade deficit; and (2) the proposal to impose a quota on lumber that would reduce Canadian exports to the United States by about one-third to one-half. Avoiding the losses that could result from a deteriorating trade relationship could be as important as the gains quoted earlier that could result from going from our present situation to freer trade with the United States.

Thus, the big issue is enhancing *and* securing our trade with the United States. Either a bilateral or multilateral agreement would give us this. The special benefits provided by one but not the other are of distinctly secondary consequence, and we can and should pursue both approaches. At the same time, we must recognize that there is little or no chance of a multilateral accord of the kind we need – that is, an accord that would open up and secure Canadian access to the US market. On the other hand, a bilateral arrangement is now a distinct possibility – but only if we move at a quick pace. Thus, the Canadian government must soon make a tough decision. It has to decide whether to take an initiative or to wait. To wait sounds like keeping our options open, but it is more likely that it would close off some of them. The chances of an agreement with the United States are probably not as good now as they would have been if we had made a more concrete commitment to negotiate three months ago, and in six months, the prospects are unlikely to be as good as they are now. We cannot ever hope for a complete consensus among Canadians; we will never be unanimous, and we are not so today. But there is now sufficient support in the business community and among the provinces to provide the basis for a strong Canadian government initiative.

A final thought

To close with more perspective, it seems to me that we must look beyond the immediate issue of liberalizing our trade with the United States to developing an economy that is able to adjust to external shocks. Liberalizing our trade with the United States should be an important component of this development; becoming competitive in the North American economy would move us most – but far from all – of the way to becoming competitive in the world economy. At the same time, a bilateral arrangement with the United States – phased over, say, a ten-year period, so that our present tariffs of 10 per cent or so would come down each year by about 1 per cent or in extreme cases, perhaps 2 per cent – is unlikely to be the toughest international adjustment we will have to make. We live in a world of flexible exchange rates, and their values change by ten times that much over a much shorter period. These days there is little preoccupation with the Tokyo Round tariff cuts because they are being swamped by exchange-rate movements of many times their magnitude. These exchange-rate shifts are in response to other shocks, such as the imbalance in US macroeconomic policies that has helped to create such a swing in the value of the dollar.

And there will be other shocks to come, including surging imports from the developing countries.

REFERENCE

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Discussion

QUESTION: What would happen if the employment guarantees in the Auto Pact were removed?

R.J. WONNACOTT (University of Western Ontario): That's a difficult question. At present, we are about $10 billion over the point at which these requirements bind. So we've got a lot of elbow room in terms of Canadian production that's not locked in by these guarantees but is taking place here anyway. This seems to suggest that we don't need the guarantees. However, our favourable situation is not quite the source of optimism that one might think because, to some degree, it reflects short-term influences, such as a more rapid recovery in the United States than in Canada, the kind of cars that were selected for production in Canada, and so on. Therefore, in terms of long-run investment decisions, the argument isn't as strong as it initially appears – although it's not without merit.

Another reason it's difficult to answer your question is that we've now had twenty years during which those guarantees have been interpreted as being permanent. And the development of the auto industry behind permanent guarantees has been quite different from what it would have been in a more competitive situation, one in which it was recognized that the guarantees would soon disappear. When you guarantee employment, you tend to get a different pattern of wage settlements than when employment is not guaranteed. Our favourable production experience in the auto industry may or may not have resulted from these guarantees, but the guarantees themselves have put the industry in a less competitive position than it would be otherwise. I can't predict what would happen if they were to disappear – except to observe that an announcement they were going to be phased out would increase the pressure on the Canadian auto industry to become competitive, and that it's likely it would adjust to those circumstances.

QUESTION: Could you tick off very briefly the advantages to the United States of a bilateral relationship with Canada?

R.J. WONNACOTT: To see one of the most important advantages to the United States, visualize a line drawn between Minneapolis and northern California. It cuts off 8 to 10 per cent of the US market. Now, imagine saying to American industry, tomorrow morning we will impose restrictions at that border similar to those that now exist between Canada and the United States. What we are talking about is a reduction of 10 per cent in the US market, a reduction that's going to be important to a lot of US firms. For example, firms that reached their break-even point at 90 per cent output are going to be cut off from the 10 per cent of the market that provides them with their profit.

Now, what we are talking about for US-located firms in a Canada/US free-trade area is an 8- to 10-per-cent *expansion* of their 'domestic' market. That's not a trivial change; it's a big source of economic gain. The per capita gains to the United States would be much smaller than those to Canada, no question about that. Moreover, the US gain might be smaller in absolute terms. (One reason is that a small country tends to get larger gains out of a free-trade arrangement.) But the point is that the United States coud expect sizeable gains from bilateral free trade.

Furthermore, as long as the arrangement involved no economic loss to the United States, I have always wondered why anyone would expect the Americans to turn it down. They have, for political reasons, been prepared to negotiate all sorts of arrangements that not only don't provide a gain but probably bring a loss. Consider the EEC. It's difficult to argue that its existence has provided any benefit to the United States, but the United States has supported it. Another example is the Caribbean Basin Initiative, which is a very strange, one-way arrangement that has US support for political reasons.

Because of the Americans' problems on their southern border, they are willing to do things for political reasons that they wouldn't do for economic reasons.

We're on their northern border and would be offering them a proposal with political advantages *and* economic gains. Although one can't foresee the outcome of any negotiations with certainty, it's unlikely we'd have a major problem.

The role of bilateral investment talks

Gary Clyde Hufbauer and Jeffrey J. Schott

THE SETTING

Canada has much to gain from trade policies that are open and outward-looking. Its heavy dependence on exports reflects its small domestic market, and because of this dependence, buoyant exports can make an important contribution to its economic growth. Since 1982, more than 50 per cent of the growth in the Canadian gross national product has resulted from an increase in exports to the United States. During this period, Canada has run a trade surplus with the United States averaging almost $16 billion US a year. More than 70 per cent of Canada's trade is with the United States, and 80 per cent of Canadian exports enter the United States duty-free. Two-way trade now exceeds $100 billion US a year.[1]

In light of these statistics, it is no wonder the Canadian minister for international trade writes that 'secure and enhanced access to the US market is an overriding objective' of Canadian policy (Kelleher 1984, 18). The strong trade interrelationship means that Canada must be wary of being caught in any US protectionist backlash that might emerge as the overall American trade deficit continues to grow.

To this end, Canada may find it attractive to proceed simultaneously with bilateral trade talks with the United States and multilateral negotiations under the General Agreement on Tariffs and Trade. Important bilateral gains could be made in sectors such as

Mr Hufbauer is a senior fellow and Mr Schott a research associate of the Institute for International Economics, Washington, DC.

urban mass-transportation equipment, telecommunications, power-generating equipment, and petrochemicals.

The advantages of a bilateral negotiation would extend beyond individual sectors. A bilateral accord would also enable the United States and Canada to present a more cohesive front in dealing with third countries. The United States and Canada have a mutual interest in strengthening the GATT trade rules, particularly in the areas of agriculture, high-technology goods and services, and subsidies. Each already benefits from international rules that discipline the trade policies and programs of all GATT member countries.

As trade talks proceed, attention should also be focused on key investment issues. At present, there is no Canadian/US agreement – such as a treaty of friendship, commerce and navigation – to provide a framework for dealing with nagging problems of bilateral investment. Yet in making their investment decisions, firms certainly consider the economic climate and the rules of the game. Recent somersaults in Canadian policy have not been conducive to foreign direct investment. The National Energy Program (NEP) actually led to net outflows in the early 1980s – primarily in the energy sector. But the Mulroney government has shifted Canada's gears and is now promoting foreign direct investment. Symbolic efforts are underway – although cautiously and slowly – to change the Foreign Investment Review Agency (FIRA) into Investment Canada; the objective is to eliminate or reduce review for most foreign investment projects in Canada. This policy has complemented the low exchange value of the Canadian dollar, which has acted as a powerful attractive force for foreign direct investment. It shifted from a net outflow of $900 million Canadian in 1982 to a net inflow of $1.75 billion Canadian in 1984 (*New York Times*, 8 December 1984, 1).

Investment issues are more or less ignored in the GATT, just as they are in the formal apparatus of Canadian/US relations. But government policies on foreign direct investment often shape trade flows. Export performance requirements linked to investment incentives both distort investment decisions concerning the location of plants and effectively subsidize future production from those plants. Restrictions on the right of establishment limit the types of activity of and increase the costs to foreign firms doing business abroad.

International investment problems invariably loom larger as trade barriers are liberalized. Particularly troublesome are investment incentives and domestic subsidies, such as research and development (R&D) grants. These issues raise the twin questions of which subsidies are excessive and which are permissible – questions that even the European Community has confronted with only modest success.

One approach is to address investment issues largely through trade measures. Trade restrictions can be designed to limit competition in the home market and thus to enhance the profitability of domestic investment. In effect, they provide incentives for foreign firms to establish plants behind protective barriers and incentives for domestic firms to stay at home.

But the use of trade restraints is only part of the investment story. Subsidies are often targeted to attract investment from abroad or to stimulate it at home. Indeed, investment subsidies can be a sensible and attractive alternative to trade protection. Trade protection is inherently connected with losing industries. By contrast, investment subsidies are more often directed towards promising activities. A free trade area raises the attractiveness of investment subsidies in search of winners, since the potential market is that much larger and the local backlash is that much weaker. It is one thing for a city to subsidize a bakery that competes with all the other local bakeries; it is quite another for a state to subsidize a software firm that sells to the world.

What makes the international resolution of investment issues particularly troublesome is that broad and conflicting principles come into play. Three sets of counterpoised principles can be identified:

– *Government sovereignty*. On the one hand, it is said that governments at the subfederal level should be allowed maximum freedom to pursue their own visions of economic paradise. If a government pursues the wrong vision, it will be disciplined both by budget constraints and by the spectre of firms and individuals voting with their feet. On the other hand, it can be argued, federal discipline of subfederal investment incentives can help prevent an escalating war of costly subsidies that outpaces the natural forces of economic discipline. (The same argument has been used to justify international discipline of national subsidies and tariffs.)

– *Economic intervention*. On the one hand, it can be argued that government should bring jobs to the people, rather than induce people to relocate in search of employment. According to this view, investment aid for depressed regions is a government responsibility. On the other hand, it is said that government efforts to channel scarce resources into depressed regions are likely to result in inefficient use of capital. Stories of unneeded roads in Appalachia illustrate this point of view.

– *Control of the national destiny*. On the one hand, it can be argued that important investment decisions – both for physical structures and for R&D projects – should be made by nationals of the country involved. On the other hand, it is often said that foreign investment brings new ideas and products and stirs up productive ferment that would not otherwise exist.

Few countries have resolved these basic philosophical questions, even in terms of domestic economic policy. If Canada and the United States are going to come to grips with trade and investment issues, the negotiated solutions must: (1) find a compromise route between these broad questions; and (2) involve the co-operation of both federal and subfederal governments.

A bilateral investment agreement might well skirt the basic philosophical questions and instead provide a framework for addressing such immediate US concerns as: (1) discrimination, especially via FIRA reviews and under the NEP; and (2) distortions caused by investment incentives and performance requirements. At the same time, a bilateral agreement could address the most urgent Canadian concerns: (1) that US firms might buy up and thus control the growth and development of the Canadian economy; or (2) that the United States might drain vital investment resources and R&D talent from Canada.

PROPOSAL

To deal with investment issues, the United States and Canada should follow the precedent of the agreement on services in the recent US/Israeli free-trade pact and develop a 'model' agreement of principles to govern bilateral investment flows. This agreement might serve as a prototype for a broader multilateral pact.

The agreement on principles should be reached between the federal governments, but each of them should undertake 'best efforts' obligations for its subfederal bodies. To reinforce such commitments, each federal government should work out separate agreements with those individual states and provinces most involved. In return for the cooperation of subfederal bodies, each federal government would try to resolve specific trade and investment problems of particular concern to industries in the states or provinces. (This is not as ambitious a venture as it seems. Ontario and Quebec account for over three-quarters of Canadian manufacturing production and are the homes of most foreign investment in Canada's nonenergy sectors. Similarly, the northern industrial states – New York, Pennsylvania, Ohio, Michigan, Indiana, Illinois, Wisconsin, and Minnesota – have the greatest concerns with Canadian competition.)

What would an agreement cover? We suggest a six-part program of principles and procedures.

- *Trade restraints.* The federal executive in each country would pledge to use bilateral trade restraints as a last resort – only after trade-adjustment and other measures had been deployed. This pledge would extend to voluntary restraint agreements, retaliatory measures such as those taken under section 301 of the US Trade Act of 1974, and escape-clause proceedings.

- *Nondiscrimination pledge.* The agreement would guarantee national treatment for foreign-owned firms with respect to all forms of regulation, including incentives for investment and R&D. Limited exceptions would, however, be made for sensitive service sectors (shipping, air transport, communications). In the case of defence goods, national treatment would require compliance with secrecy and classification rules. This nondiscrimination pledge would be more comprehensive than the OECD declaration on national treatment, which allows a wide range of exceptions. It would be more similar to the provisions of the model US bilateral investment treaty (BIT), but it should cover certain sectors excluded from the BIT, such as banking, insurance, and energy.

- *Right of establishment.* The agreement would provide for free establishment for all interested firms, subject to limited exceptions for national security reasons and specially designated 'sensitive' sectors. As part of the agreement, an understanding would be sought on appropriate criteria for federal, state, and provincial regulations concerning the establishment of banks and insurance companies. Each federal government would consult with its respective states or provinces in developing guidelines, but in the first instance, the guidelines would not be binding on subfederal bodies.

– *Investment incentives.* The federal, state, and provincial governments would pledge to review the level of incentives periodically, with a view to reducing their extent. States or provinces (or parts of provinces) with lower unemployment levels would be the first to reduce their incentives. For the purpose of national statutes on countervailing duties, investment incentives would be regarded as domestic subsidies and allocated over the first five years of total production. Each government would pledge that incentives would be provided free of trade-distorting performance requirements – for example, local-content rules, and minimum export requirements.

– *Transparency.* Each government would give notification *ex ante* of the types of incentives and the circumstances in which they are to be given, with broad indications of available budget ceilings. Further, each government would give notification *ex post* of all federal, state, or provincial investment incentives granted to a single enterprise over a threshold of, say, $5 million US. The *ex post* notification would be given on a confidential basis to the quadripartite binational commission described below.

– *A quadripartite binational commission (QBC).* A QBC would be established, involving representatives of federal, state, and provincial governments. The QBC would have several powers and responsibilities: it would monitor incentives, both as to type and amount; it would track all investment decisions of foreign subsidiaries (those foreign controlled to the extent of 50 per cent or more); and it would track significant investment decisions (say, greater than $50 million US) by other companies. The QBC (like the GATT) would serve as a repository for 'investment bindings' between provinces and states. At the initiative of any member, the QBC would review the level of concentration of foreign direct investment in a particular sector and could authorize a temporary derogation from the nondiscrimination and right-of-establishment rules. In addition, it could authorize exceptions from bound investment levels if the local economy or the loss of trade to a particular province or state so warranted. Finally, the QBC would arbitrate disputes concerning particular investment bindings or broader principles.

In short, the QBC would serve as both a clearinghouse and a mediator. As trade barriers between the United States and Canada continued to fall, the QBC could provide an invaluable means to ward off new and subtle forms of protection via investment controls and incentives. In addition, it could be a useful model for a broader multilateral forum, perhaps under the GATT umbrella. A Canada/US agreement could thus serve as the precursor of more extensive GATT discussions on trade-related investment issues during the forthcoming round of trade negotiations.[2]

NOTES

1 The United States also has an important stake in trade with its most important partner. Almost half of the growth in US exports since 1983 has gone to Canada.

2 For an elaboration of the issues that should be negotiated in a new round, see Hufbauer and Schott (forthcoming).

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Mechanics for the ratification, enforcement, and abrogation of international agreements in US law

John H. Jackson

I have been asked to comment on the framework of United States law for the mechanics of ratification, enforcement, abrogation, and other related matters of a Canada/US agreement, such as a free-trade agreement. It is obviously a timely and important subject. Canada has had some experience with the problem of US law and the US Constitution and can reasonably want to know some of the specific aspects of this subject so as to prevent surprises in future relations between the two countries. For example, Canadian officials have often complained that the United States did not adequately implement its obligations under the 1967 Antidumping Code of the General Agreement on Tariffs and Trade. Canada argues that it made substantial changes in its internal dumping procedures as part of its obligations under the Code but that until the 1979 Antidumping Code replaced the former one, the United States did not implement the antidumping rules adequately to protect Canadian interests. US congressional opposition to the 1967 Antidumping Code is blamed for this result.

In 1965, Canada and the United States entered into an agreement on automotive products that was taken by the US executive to Congress for approval. Congress enacted legislation to implement it; however, members had a number of criticisms about the agreement. Although there has apparently been no significant problem of lack of US implementation, these criticisms do give notice that Congress has an important role in this type of activity.

Professor Jackson is Hessel E. Yntema Professor of Law at the University of Michigan Law School.

The results of the Tokyo Round were put in place in the United States in 1979 after being approved by the Congress under its 'fast-track' procedure for dealing with international agreements. Notice that Congress explicitly prevented the Tokyo Round agreements from having any 'self-executing' effect in United States law; instead it enacted statutes to bring into US law what it deemed to be the international rules. Once again, there is no evidence (at least not yet) that Canadian interests have been harmed by this process, but national interpretation of international obligation always poses the risk of divergent interpretation.

In this paper I will briefly outline the constitutional and other laws of the United States as they bear on potential trade agreements between the United States and Canada.

AN OVERVIEW OF THE ISSUES

The starting point is, of course, the Constitution of the United States. It builds into the structure of the US government the important principle of separation of powers. The basic policy goals behind that have been elaborately described in other works. For our purposes, it is important to note that the concept of separation of powers has two dimensions: (1) the separation of powers between the federal government and state governments; and (2) the separation of powers among the several branches of the federal government, namely the executive branch, Congress, and the courts. The separation of powers between the executive and Congress is particularly important with respect to foreign economic affairs. Consequently, much of this paper will focus on that particular element of the US Constitution, as it is elaborated through statutes and other laws of the United States.

Federal and state powers and international economic agreements

The US Constitution expressly prohibits treaties between states of the United States and other countries, but it does allow 'compacts' if Congress approves them. The distinction between 'compacts' and 'agreements' has never been well articulated. In addition, US states and other countries or provinces often make relatively informal arrangements that, although probably not legally binding under either international or domestic law, nevertheless are effective because of self-balancing features in them or the goodwill of the parties concerned in following them.

An important consideration that is sometimes raised is whether the state powers under the US Constitution in any way limit the type of activity that the federal government can undertake in the conduct of foreign affairs and the implementation of international agreements. The brief answer appears to be no; that is, it is generally thought that the allocation of powers to the states does not inhibit what the federal government can do by way of entering into an international agreement, and implementing or effectuating it in US law. In short, the federal government, if not supreme in this area, is very nearly so. Thus, the federal government can enter into international agreements on subjects that it could not otherwise regulate, and the courts have upheld implementation of such international agreements (*Missouri* v. *Holland*, 252 US 416 (1920)). We should perhaps not go so far as to say state powers could never limit the federal power here, but it certainly would be rare. (One matter that is expressly allocated to the states under the twenty-first amendment to the Constitution is the regulation of alcoholic beverages. Even here, the dimensions of the states' power are not entirely clear, but it is possible, because of that particular amendment and its history, that the Supreme Court would prevent the federal government from establishing international agreements that infringed too much on what appears to be a state-government monopoly of power.)

One area in which this general issue of state powers as a limit on the federal power to enter into international agreements has been articulated is the question of government procurement. Analysts ponder whether an international agreement by the federal government limiting discrimination of not only federal but also state government entities in their purchases could be enforced in the courts of the United States. Although the question is not explicitly clarified by any existing court decision, the preponderance of opinion seems to be that the federal government would have the authority to implement an international agreement that limited state-government purchasing procedures.

Separation of powers at the federal level

The US Constitution delegates powers to three separate branches of the federal government: the executive branch, Congress, and the courts. With respect to foreign affairs, the courts are generally reticent to step in too heavily, so the problem of executive/ congressional relationships is all-important. Indeed, the structure of the US government makes that relationship the single most important influence on the foreign relations of the United States. With respect to economic affairs, the Constitution even goes further. Because clauses in the Constitution expressly delegate power to Congress to 'regulate commerce with foreign nations' and to 'levy and collect . . . duties', it has traditionally felt that it has a special monopoly of power with respect to the international economic relations of the United States. This perception is often stated in congressional reports on legislation affecting international economic affairs, and the president's power to enter into international economic agreements is jealously guarded against. Nevertheless, over many decades and several centuries, Congress has delegated to the president a wide variety of authorities, which often allow him to find implicit if not explicit authority to proceed with many international economic endeavours.

The relationship of the executive and Congress needs further discussion, which constitutes the remainder of this brief paper. A series of different functions relate to international agreements; each of these functions can be examined separately. Specifically, one can ask whether the president has authority to proceed without congressional approval or delegation of authority to him, by statute or otherwise, in connection with each of the following activities:

1 Negotiating internationally.

2 'Signing' an international agreement *ad referendum* (that is, with the understanding that it must be approved later).

3 Definitively accepting an international agreement as an international-law obligation (as distinguished from its impact on the domestic law).

4 Implementing an international agreement into domestic US law either by direct application of the agreement by courts of the United States or through statutes or regulations that 'transform' the international rule into domestic law.

5 Administering the international agreement, in the sense of tending to its ongoing viability through processes that might include voting in an international body, amending the agreement, deciding to terminate it under express or implicit authority in the agreement itself, and handling and disposing by settlement of various disputes under the agreement.

Each of these issues is now taken up. The most important are the fourth and fifth; consequently some emphasis is placed on them.

NEGOTIATING AN AGREEMENT

In general, it is considered that the president has the power merely to negotiate internationally on any subject. This does not give him the power to accept an international agreement; consequently, negotiating partners may have little or no interest in dealing with a president whom they feel does not have the power to deliver in the end. Nevertheless, the president has traditionally assumed and practised the power to negotiate. This includes even the power to negotiate informal agreements (sometimes called voluntary or gentlemen's agreements), which are generally not considered binding under international law. Whether Congress could, by statute, prohibit the president from negotiating on some particular matter is not clear, but presidential advisers would probably say no.

'SIGNING' AN AGREEMENT

Merely 'signing' an international agreement – in the sense of the Vienna Convention on the Law of Treaties, whereby the signing certifies the results of a negotiation but does not accept those results as a binding legal obligation – probably is simply a subcategory of the president's power to negotiate. He or his officials can apparently 'sign' on an *ad referendum* basis anything negotiated internationally. This means that it is understood that the agreement is not definitively binding on the United States until some subsequent act of approval has occurred. Possible exceptions are those few cases in which the president has direct authority to accept an international-law obligation, and his signing is deemed to be such acceptance.

ACCEPTING AN AGREEMENT AS AN INTERNATIONAL-LAW OBLIGATION

Whether the president has the power to accept international agreements as binding international-law obligations for the United States is the most complex and most significant issue of the president's authority with respect to international agreements. Generally it is considered that the president has five types of authorities to enter into and accept for the United States an international agreement:

1 *A 'treaty', in the US constitutional sense of an international agreement that must be submitted to the Senate for 'advice and consent' by a two-thirds vote.* The United States Constitution expressly mentions only this mode of completing an international agreement, but it has become subordinate, at least in numbers, to the executive agreements discussed below. It should be noted that the terms 'treaty' and 'executive agreement' used in United States constitutional law are 'treaties' in international law in the sense of being binding and subject to the Vienna Convention on the Law of Treaties. This unfortunate difference of terminology between US jurisprudence and international jurisprudence often causes considerable confusion.

2 *An executive agreement approved by Congress through advance delegation.* In this situation, Congress enacts a statute granting the authority to the president to negotiate and enter into some future international agreement. This has commonly been the approach of the United States Trade Agreements Program, beginning with the 1934 Reciprocal Trade Agreements Act, which authorized the president and his officials to negotiate and enter into international agreements for the reciprocal reduction of tariffs. This pattern has persisted to this day through renewals of the statutory formula, although there have been gaps in this authority and its most recent expression by Congress has now expired under its own terms.

3 *An executive agreement authorized subsequently by Congress.* The president can, of course, negotiate any international agreement, particularly on economic affairs, and then submit that agreement to Congress for approval. (He could also submit it as a treaty to the Senate for advice and consent. The distinction between the types of instruments that should be submitted as treaties and those that should be submitted to Congress as a whole is not entirely clear, although the State Department has attempted to articulate some guidelines.)

Under this method of approval, Congress passes a statute (to which the president must agree) authorizing the president to accept for the United States a specified international agreement. This is basically the approach taken by Congress in recent decades for the approval of agreements on nontariff barriers such as the many-sided codes negotiated in the Tokyo Round and approved by Congress in the 1979 Trade Agreements Act.

The basic problem is that this approach leaves negotiators somewhat at risk, since they cannot always be sure that Congress will approve the results of a negotiation. Negotiators from other countries dislike this approach since they may find that after they think they have a final agreement, Congress causes the executive to reopen it for further negotiation; this is likely to mean, of course, that Congress is demanding more concessions and that the level of concessions previously agreed to simply becomes the basis for further negotiation. Thus, foreign political leaders can find that they have spent considerable domestic political capital only to be required to spend some more if they want to complete the final agreement.

It was these considerations that led the executive and Congress, in the 1974 Trade Act, to formulate procedures that give greater assurance of Congressional approval of international agreements. The principal result of these efforts was the 'fast-track' procedure, which is described in the next section.

Even though the 'fast track' is an accelerated way for Congress to approve an international agreement and includes some self-imposed limitations on congressional procedures, nevertheless, it is reasonably clear that a nation that negotiates with the United States to formulate an international agreement that must subsequently be submitted to Congress inevitably finds that it is in a certain sense negotiating with the Congress. During the negotiation process, that nation's officials, as well as US executive branch officials, have to pay a great deal of attention to the views of Congress.

4 *An executive agreement under treaty authorization.* Sometimes the president is deemed to be granted authority under a treaty or other executive agreement to enter into lesser or derivative executive agreements, designed to carry out the purposes of the larger treaty, without further submission to Congress.

5 *An agreement under the inherent powers of the president.* The most controversial powers of the president are those that he sometimes claims enable him to enter into international agreements in circumstances in which, he argues, he need not obtain input from either the Senate or the House of Representatives. There are clearly a few types of agreements for which the president has this authority, and the Supreme Court has upheld some. These tend to be agreements that are closely allied with specifically delegated presidential authorities,

such as his authority as commander in chief or his authority to 'receive diplomats' (see, for example, *US* v. *Belmont*, 301 US 324 (1937)). Sometimes it is also argued that the president's role as chief executive gives him this type of authority. In any event, if the president tries to stretch this authority, he usually runs into considerable opposition in Congress.

The 'fast-track' method of approving international agreements

In seeking to provide a modestly improved chance of congressional approval of international agreements so as to induce representatives of other countries to negotiate with US representatives, Congress in 1974 introduced a novel technique for considering such approval. In sections 102 and 151 of the 1974 act, Congress, while rejecting a congressional-veto approach, provided for amendments in the rules of both the House and the Senate for considering a bill to approve and implement an international agreement. The rule changes have three essential characteristics:

1 Such a bill is not amendable in either house of Congress.
2 Such a bill can have some consideration by committee, but it will be automatically discharged after a certain time (so a committee cannot 'bottle it up').
3 Debate concerning the bill on the floor of either house has a limited duration (once again, so it cannot be 'debated to death').

Connected with these procedures were requirements that the executive give advance notice to Congress of its intention to submit an international-agreement-approval bill, and that during the period of advance notice the executive consult with the Congress.

These procedural innovations worked very well when it came time to approve the results of the Tokyo Round. In early 1979, the executive gave notice to Congress in quite elaborate detail, transmitting the draft texts of the international agreements, which were nearly completed. During this period of consultation, relevant committees of both houses of Congress held hearings and then, in private session, had extensive discussions with the executive branch about what members of Congress felt should be included in the bill to be submitted and how it should be phrased. Thus, although the bill when submitted was unamendable, members of Congress felt they had considerable inputs to the formulation process. In several instances, the legislators had influenced the US negotiators to go back to their counterparts and negotiate modest changes in the international drafts to accommodate previously unforeseen problems. Congress was so satisfied that when the bill that became the Trade Agreements Act of 1979 was ultimately introduced, it passed the Senate by a vote of 90 to 4 and the House by a vote of 395 to 7. In addition, Congress extended the authority of the 'fast-track' procedure by an additional eight years, which means that it now expires on 3 January 1988.

The US/Israeli free-trade agreement

In 1984, the US government and the government of Israel decided to enter into negotiations for the formulation of a free-trade agreement between these two countries. There were various economic and non-economic motives for such an agreement, including the problem foreseen for US trade when a similar agreement between Israel and the European Economic Community would go into force. The objective was to negotiate an agreement that fully complied with Article 24 of the GATT (concerning free-trade agreements). The results of this negotiation have been finalized in an agreement signed by the two governments and submitted to Congress under a 'fast-track' procedure modified by the Trade and Tariffs Act of 1984. In May 1985, Congress approved the legislation authorizing the US/Israeli agreement.

The process of formulating this agreement and obtaining Congressional approval is obviously pertinent to a potential Canada/US negotiation and agreement of a similar sort and thus could profitably be the subject of considerable study by Canadians. Without being too detailed in this brief paper, several points can be made. The 1984 act expressly provides for modified 'fast-track' treatment of the US/Israeli agreement, but as to future agreements of a similar sort, it is not as clear whether that procedure will be available. Of course, any agreement negotiated could be submitted to Congress under its normal procedures, but doing so would lose some of the advantages of the 'fast track' (nonamendability, automatic committee discharge, and limited debate). It must also be remembered that the 'fast-track' procedure as a whole terminates near the beginning of 1988, unless the Congress is willing to renew it before that time. (There is some talk that it will be necessary for Congress to renew that procedure in the context of a newly launched GATT trade-negotiating round.)

Section 406 of the 1984 act has a provision of considerable significance. This section provides that no free-trade agreement entered into with Israel

> may affect in any manner, or to any extent, the application . . . of Section 232 of the Trade Expansion Act of 1962, Section 337 of Title VII of the Tariff Act of 1930, Chapter 1 of Title II and Chapter 1 of Title III of the Trade Act of 1974, or any other provision of law under which relief from injury caused by import competition or by unfair import trade practices may be sought.

The references in this section are to various standard trade laws of the United States, including a national security provision, an unfair-practices provision (Section 337), the escape clause, and countervailing duties, as well as 'any other provision' relating to unfair trade practices. The congressional views embodied in this section had been foreseen as a result of consultations with Congress in advance of the negotiation between the United States and Israel. In short, the Congress mandated that all the United States' normal trade laws apply to trade under the US/Israeli agreement, except, of course, the tariffs (since the agreement provided duty-free treatment). There was a very slight modification of the escape clause in the 1984 statute.

This parameter imposed by Congress on the US/Israeli negotiations could well be a precedent for future negotiations, tending to prevent the carving out of any special favours, such as selectivity or non-most-favoured-nation treatment for free-trade partners in the context of unfair-trade-law proceedings in the United States.

IMPLEMENTING AN AGREEMENT IN US LAW

Some countries have what is called a 'dualist' approach to international agreements: no such agreement becomes domestic law, and its norms or implementation must be enacted into statutory or other positive regulatory law before they become part of the domestic jurisprudence. Other countries have a 'unitary' system: their jurisprudence deems *all* international agreements to be part of the domestic jurisprudence. The United States is in a mixed situation in this regard. The courts have generally held that an international agreement that is 'self-executing' becomes part of US jurisprudence, enabling courts to take direct cognizance of the treaty or other agreement and enabling private parties to rely upon the agreement in their various lawsuits. The jurisprudence in the United States is not entirely clear as to what is 'self-executing', although there is some literature on the subject and a number of cases have addressed the point. Basically, the idea is that when the structure of the treaty (and the intention of the drafters) is such that it was designed to become part of the domestic jurisprudence, it will be so regarded. Thus, language along the lines of 'each individual shall have the right to . . .' suggests a treaty is self-executing. On the other hand, a treaty that says 'each government or contracting party shall take such measures as are necessary to implement the obligations herein' is clearly not self-executing. Sometimes Congress, in approving an agreement, specifies whether it is to be deemed self-executing, and the courts seem disposed to follow the congressional specification. This was the approach used in the 1979 Trade Agreements Act in which the Congress explicitly stated that the agreements resulting from the Tokyo Round would not be self-executing.

The issue of self-execution is comparable (but not identical) to what in some societies is termed 'direct applicability'. It is only one of three essential questions regarding the status of an international agreement in domestic law. In addition are the questions of (1) whether a particular individual or firm has the right to invoke the agreement (a sort of 'standing' concept), and (2) the 'hierarchy of norms', which means the question of which norm will prevail in the event that the international agreement directly conflicts with some other domestic norm. These are issues that I am not able to go into in this brief paper.

ADMINISTERING AN AGREEMENT

What is the allocation of powers in the US federal government with respect to various decisions about administering an international agreement during its period of vigour? The situation in the US jurisprudence is not entirely clear, but in general, the president has performed and seems to be recognized as having the power to tend to the day-to-day ministerial acts required under an international agreement, which certainly includes dealing with (and settling) disputes and voting in international bodies. (Sometimes the Congress specified restrictions on voting rights, such as it did in the Bretton Woods Agreements Act as amended.)

One significant issue that has arisen several times in recent years is whether the president has authority to terminate an international agreement without consulting Congress or the Senate. This question has engendered a fair amount of literature; the answer probably depends very heavily on the particular wording of the treaty or the wording of the approval instrument passed by Congress.

Canada's constitutional quandary: the federal/provincial dimension in international economic agreements

Murray G. Smith and Debra P. Steger

Since Canada is a relatively small and trade-dependent economy, its access to export markets has a significant influence on growth prospects and investment opportunities. And since Canada lacks assured access to a large, high-income market, trade negotiations can offer us significant opportunities to improve our situation. Distinctive features of our federal system, however, create challenges for Canadian participation in future international trade negotiations. Many of the practices and policies that are likely to be key issues in future negotiations are within the exclusive legislative jurisdiction of the provinces. Thus, effective Canadian participation in international economic agreements is going to require new approaches to involving the provinces in the negotiation and implementation of these arrangements.

THE INTERNATIONAL CONTEXT

The scope of future international negotiations is likely to be far broader than that of the Tokyo Round of multilateral trade negotiations, which, in turn, was a far more ambitious undertaking than any previous negotiations. Negotiations within the General Agreement on Tariffs and Trade have achieved considerable progress towards reducing tariffs and the disciplining of nontariff barriers. However, important issues remain to be resolved in achieving freer trade in goods. The global trend to increased economic interdepen-

Mr Smith is a member of the C.D. Howe Institute. Ms Steger is a lawyer practising with McCarthy & McCarthy in Toronto.

dence has created pressures for governments to insulate their citizens from the vicissitudes of world markets. As a result, there has been increased resort to contingent protection mechanisms. Government procurement preferences and product standards have become more prominent forms of nontariff barriers.

Future negotiations are also likely to venture into the relatively uncharted areas of trade in services and of policies towards direct investment. At present, government policies pertaining to service industries and to firm behaviour are subject to international commitments only to a very limited extent. Extending the GATT concept of national treatment to trade in services and direct investment would require a reassessment of many domestic regulatory policies and practices.

The issues subject to negotiation are much more extensive than in the past, and the negotiating process has become more complicated as well. The GATT, the premier forum for trade negotiations during the postwar period, will remain the key bulwark in the international trade-relations system. An inertia has developed in the GATT process, however, that inhibits progress towards freer trade and impedes the realization of Canadian negotiating objectives.

The problems that beset the GATT can be briefly summarized. First, the formation of the European Community, combined with its association agreements with former European Free Trade Association (EFTA) countries and preferential arrangements with many developing countries have undermined the GATT system. (Patterson 1983) Second, many developing countries that have acceded to the GATT have sought preferential treatment and resisted accepting obligations for their own commercial practices. (Tumlir 1983)

Third, the congenital defects of the GATT have become increasingly troublesome – particularly in areas such as dispute resolution – and it has become virtually impossible to amend or to adapt it (Jackson 1980). This blockage in the multilateral system has resulted in institutional innovation. In the Tokyo Round, this took the form of separate agreements – the codes – that sought to limit nontariff distortions to trade. In most cases, only the industrial countries participated in these agreements, a process sometimes referred to as plurilateral negotiation or GATT-plus.

An essential feature of the codes negotiated during the Tokyo Round is that rights of access to a signatory's domestic market are available only to other signatories. Thus, the codes offer conditional most-favoured-nation (MFN) treatment. The rights under each code are conditional upon a country's accepting the code's obligations.

The purpose of these negotiating innovations is to ameliorate the incentive problems in trade negotiations that Richard Cooper refers to elsewhere in this volume. The plurilateral negotiations reduce the free-rider problem that occurs in MFN tariff negotiations. Plurilateral negotiations may not, however, resolve what is sometimes referred to as the least-common-denominator or 'foot-dragger' problem – trade liberalization is constrained to the level permitted by the major industrial trading bloc least willing to reduce or to eliminate particular trade barriers or nontariff distortions.

Section 401 of the United States' Trade and Tariff Act of 1984 is a significant innovation intended to alter the incentives for countries to engage in international trade negotiations. It grants the US president the authority to enter into negotiations with other countries to establish free-trade areas (FTAs). The rationale for the new approach of negotiating bilateral free trade areas was recently explained by US Secretary of State George Shultz:

> From a global perspective, a splintering of the multilateral trading system into a multitude of bilateral arrangements would be a backward step. Bilateral free trade agreements, however, such as we have negotiated with Israel and have offered to discuss with other countries, need not have this result; they can stimulate trade and strengthen the multilateral system. Free trade agreements are sanctioned by the international rules and involve a tighter trade discipline; they can promote freer trade than the multilateral system is currently prepared to accommodate. Our hope, nonetheless, is that the example of greater liberalization – and the recognition that the United States can pursue another course – will help motivate a larger group of nations to tackle the job of expanding trade on a global basis. (Shultz 1985)

Elaborating on this theme, the report of the US Council of Economic Advisers says, 'The possibility of FTA . . .offers the United States and others the option of using a free-trade instrument, rather than protectionism, as a lever against protectionist countries' (United States 1985, 126). The Council argues that the preferred access available to members of an FTA provides an incentive for other countries to engage in trade negotiations. This strategy of liberalizing trade is preferable to attempts to use threats of trade restrictions to induce other countries to negotiate. Threatened protectionist measures would impose costs on the home country, and thus the threats lack credibility. Furthermore, the Council says, implementing the threats would invite retaliation.

Section 401 of the Trade And Tariff Act of 1984 provides that in response to a request from a foreign country, 'fast-track' congressional procedures are available for both the granting of negotiating authority to the US president and the subsequent implementation of the negotiated agreement. Congressional approval is required for implementation, but time limits are imposed and the resolution can only be approved or rejected. The effect of these procedural requirements is to prevent individual members of Congress, acting on behalf of particular interest groups, from delaying passage or altering provisions of an agreement.

Canada's negotiating options

In the current international environment, Canada has a broad range of negotiating options. The first level of negotiations could be broadly multilateral, conducted with a large number of countries in a GATT context. The second level of negotiations could be plurilateral, involving small groups of industrial countries that can move ahead on particular issues. The third level could be bilateral negotiations with the United States in the context of the new FTA negotiating authority embodied in US trade legislation.

Some or all of these negotiating options could be pursued along parallel tracks. Pursuing bilateral negotiations would not preclude active Canadian participation in multilateral or plurilateral negotiating processes. Indeed, the various options could be complementary. If the United States and Canada developed new approaches to reducing impediments to trade in services or in investment issues, these would influence what is likely to be a fluid multilateral agenda.

Canada faces a challenge in responding to the broad range of issues that are likely to arise in future trade negotiations. On one level, the choice of trade options is very simple. Canada has to decide whether it wishes to take an active approach by requesting negotiations with the United States under the FTA negotiating authority or to take a more passive approach and wait for the multilateral agenda to unfold. Regardless of which of these two basic strategies Canada chooses, to negotiate effectively it will have to develop greater coherence of purpose in both formulating strategic goals for trade negotiations and demonstrating the political maturity to make – and to keep – international economic commitments.

BILATERAL NEGOTIATIONS

This paper focuses on bilateral negotiations between Canada and the United States. The overwhelming significance to Canada of the bilateral economic relationship makes negotiations with the United States a dominant concern whichever negotiating options Canada elects to pursue. Bilateral negotiation of an FTA also could break new ground internationally in liberalizing trade in selected services and other areas.

Although we have suggested that the scope of future negotiations, either bilateral or multilateral, is likely to be much broader than that of previous negotiations, it will not be nearly as broad as some people suggest. Applying the GATT concept of national treatment more broadly does not imply the harmonization of domestic policies, such as the provision of health care and welfare programs. Rather, the emphasis will be on avoiding discriminatory domestic policies that alter trade and investment flows.

Take the broad area of tax-subsidy policies, which involves some of the most contentious issues in international economic relations. Canada and the United States recently concluded a bilateral tax treaty, so those issues are unlikely to be reopened in the near future. Of course, major changes in the US tax system would alter economic incentives and create pressures for changes in the Canadian tax system, but these pressures would operate regardless of whether there is any further movement towards freer trade.

Subsidies and countervailing duties

Perhaps the most contentious issue in Canadian/US economic relations is that of subsidies, whether they take the form of grants, low-interest loans, equity infusions by government, tax incentives, or other measures. The United States has developed a mandatory, quasi-judicial regulatory mechanism for investigating the subsidy practices of other countries and levying countervailing duties on imports if material injury to a US domestic industry is demonstrated.[1] Given that 75 per cent of Canadian exports are shipped to the United States, US countervailing duties have much greater significance for Canada than for other industrial countries. The evolution of US countervailing-duty laws over the last two decades has broadened the definition of subsidy, a development that represents a growing encroachment on Canadian economic sovereignty.

The popular metaphor in Washington discussions of trade policy today is 'the level playing field'. From a Canadian perspective, current US countervailing-duty law does not create a level playing field. The US Department of Commerce investigates only subsidies of other countires; it does not examine whether the US domestic industry also receives a subsidy. To give just one example, the assistance package Canada recently offered Domtar was apparently structured so that it would provide a level of assistance similar to that available in the United States from industrial development bonds. Unfortunately, if a petition were filed seeking a countervailing duty on Domtar's exports to the United States, when the US Department of Commerce calculated the amount of the subsidy, it would have to disregard the availability of this US assistance.

It does not seem feasible nor desirable for Canada and the United States to attempt to duplicate the European Community's mechanisms for limiting subsidies. (The European Commission can disallow the subsidy practices of member countries.) Certainly, it can be argued that the EC system is not very effective. But even if it were, it is not an appropriate model for bilateral relations between the United States and Canada. Given the asymmetry in the sizes of their economies and their populations, it seems unlikely that the two countries would agree to cede sovereignty over subsidy policies to a supranational institution such as the European Commission.

Instead, it may be possible for Canada to negotiate changes in the criteria for the application of contingent protection mechanisms – particularly the definition of subsidy – in order to remove some of the anomalies that exist and to prevent new ones from being introduced.[2] Such negotiations could be difficult, however, because there is strong support in Congress for US trade legislation. It is significant that the US/Israel free-trade agreement does not affect in any way US antidumping or countervailing-duty legislation. It must be noted, however, that given the relatively small volume of trade between Israel and the United States, the granting of the injury test greatly reduces the likelihood that Israel will be subject to countervailing or antidumping duties.

Government procurement

The asymmetry in the size of the US and Canadian economies can lead to perceptual problems in the negotiation of bilateral agreements. Consider government procurement. The approach taken in negotiation of the procurement code during the Tokyo Round was to compare the value of purchases covered by the agreement in different countries, an analogy with tariff negotiations based on the volume of trade covered by particular concessions. This approach to government procurement would pose problems for a country with an open economy, such as Canada, in negotiating with the larger, less open United States. In the absence of procurement preferences, a dollar of government purchases in Canada has a much larger import content than a dollar of government purchases in the United States. What would be the appropriate rule? One measure would be the ratio of the two countries' populations – about 9.5 to 1. Another candidate would be the ratio of their respective GNPs – about 11 to 1.

The asymmetry in the quantities of government purchases is sharpened by the differences in the two federal systems. In contrast to the Canadian federal government, the US federal government is responsible for a larger share of direct purchases; it also engages in many cost-shared programs. The Canadian federal government, on the other hand, normally gives transfers to the provinces, which make the actual purchases. Thus, an agreement on procurement that involved only the federal governments of Canada and the United States would be very unlikely to appear balanced to US negotiators and politicians. Further progress on bilateral or plurilateral negotiations to remove US government procurement preferences that affect Canadian exports would, therefore, likely require that state and provincial governments participate in the agreement.

But consider the negotiation of such an agreement. It is possible to conceive of the Canadian provinces' participating in such negotiations in concert with the federal government. The situation would be unwieldy, but federal/provincial negotiation is an ongoing feature of

Canadian executive federalism. It is difficult, however, to imagine all fifty American states participating in such negotiations.

Now consider implementation of such an agreement. The US federal government is in a stronger constitutional position than the Canadian when it comes to negotiation about the practices of subnational governments. The US federal government has a strong presumption of pre-eminent jurisdiction in the negotiation and implementation of those international economic agreements. As John Jackson concludes:

> One can say with considerable but not perfect assurance that in the area of foreign affairs, and particularly in economic affairs, it is hard to conceive of an action taken by the U.S. federal government that would not be supported by the Supreme Court in the event of direct conflict with state actions. This would be true whether that action was administrative or legislative, whether it was accomplished by an international agreement duly approved by the Congress, the Senate, or the President under his authority, or whether it was accomplished by other types of actions authorized by the Constitution or statutory delegations of power. (Jackson 1984b, 144-5)

The obstacles to the US federal government's negotiating and implementing international economic agreements involving state governments' practices are predominantly political rather than constitutional. The US federal government would have great difficulty making commitments about state practices if Canada could not make similar commitments on behalf of the provinces. Yet the Canadian federal government does not have the same constitutional authority as the US federal government.

CANADA'S CONSTITUTIONAL PROVISIONS

Constitutionally, the Canadian federal government has the power to negotiate, sign, and conclude international agreements. Treaty-making power belongs exclusively to the federal Crown – that is, the Cabinet (*AG Canada* v. *AG Ontario* 1937). The provinces do not have any competence to conclude international agreements. All treaties do not require approval by Parliament; however, international agreements having great political significance, affecting domestic law, or requiring the expenditure of public money are submitted to it (Jacomy-Millette 1975, 134).

Most treaties in the past have been made the subject of domestic legislation, a procedure that is necessary to incorporate their provisions into Canadian law and sometimes to alter existing legislation (Jacomy-Millette 1975, 131, 196, 234; Castel 1965, 852). Implementation is complicated by the fact that the Canadian system divides jurisdiction between the federal government and the provinces under the Constitution. The federal government does not have the sole power to enact legislation to implement international agreements. Depending upon the subject matter of a treaty, the provinces or the federal government may have exclusive jurisdiction to implement some of its provisions (Castel 1965, 112, 245).

The issue of provincial implementation arises not only in negotiations about government-procurement practices but also in other important areas, such as trade in services. Since the provinces have exclusive jurisdiction over 'property and civil rights', many of the regulatory policies that can create nontariff barriers to trade in services are under provincial control.

Let us illustrate with four topics likely to be included in either a multilateral or a bilateral trade agreement.

Product standards

If the regulation of standards is concerned with the production and sale of the products of a single industry and not explicitly with the extraprovincial distribution of these products or their movement through any channels of trade, the provinces have exclusive jurisdiction under Section 92(13) of the Constitution Act to enact regulations (*Labatt Breweries of Canada* v. *AG Canada* 1980).

Provincial legislative authority does not extend to the control or regulation of the marketing of products in interprovincial or export trade. That does not mean, however, that the federal government necessarily has the power to regulate interprovincial or international trade in particular commodities (*Central Canada Potash Company Limited* v. *Government of Saskatchewan* 1979; *Canadian Industrial Gas & Oil Ltd.* v. *Government of Saskatchewan et al.* 1977). Thus, although a principal object of federal regulation of the wheat industry in the 1920s was to protect external trade in grain, because the legislation also affected local concerns (for example, it regulated certain occupations in the provinces through a licensing system), it was impugned as *ultra vires* in *The King* v. *Eastern Terminal Elevator Company* (1925). Essentially, if federal legislation has the effect of regulating transactions within a province, even if its purpose is to regulate interprovincial or international trade, it will be found *ultra vires*.

Government procurement

How governments go about their business lies outside constitutional strictures. Since governments generally spend public money by means of executive and not legislative actions, their purchasing activities are generally not reviewable in the courts. However, if legislation or regulations were passed to implement an international agreement, the provinces would have the authority to bind the activities of their own governments, agencies, and Crown corporations and the federal government would have the same authority over its agencies and corporations.

Trade in services and investment

When services (such as banking and data transmission) and investment flows cross provincial or international boundaries, the federal government has the authority to regulate them. Unlike the US federal government's sweeping powers over most economic and trade areas under its commerce power, however, the Canadian federal government's trade and commerce power has been very narrowly interpreted in the courts. The criteria outlined for a valid exercise of the trade and commerce power, should one ever be found to exist, include:

- The regulatory scheme must be national.
- The scheme must be supervised by a federal agency.
- The legislation must deal with trade in general, not with trade in a particular commodity.
- The provinces must be constitutionally incapable of enacting such legislation.
- The legislation must extend to all provinces. Failure to include one or more would jeopardize the successful operation of the regulatory scheme.[3]

The Constitution clearly does not provide the federal government with the authority to implement international treaties in areas that impinge on provincial jurisdiction. The federal government can neither pass legislation on matters assigned to the provinces nor ensure that the provincial governments comply with Canada's international obligations.

Although one would expect that the enforceability of an international trade agreement would be of particular concern to the smaller, more trade-dependent country, Canada's constitutional provisions give the United States grounds for concern about Canada's ability to implement and abide by international commitments.

WHAT ARE THE ALTERNATIVES?

Although it is clear that the federal government has the exclusive power to conduct external affairs and to conclude international agreements on behalf of Canada, it does not have the authority to implement all of the provisions of international treaties or to regulate the full spectrum of economic activity relating to foreign trade. Given this situation, what can be done to facilitate the negotiation and implementation of trade-liberalizing arrangements?

One alternative is to amend the Canadian Constitution to give the federal government authority to negotiate and to implement international agreements, thereby overriding provincial jurisdiction. This amendment would involve a substantial redistribution of power in the Canadian federal system; consequently, it appears unlikely.

Another alternative is to rely on voluntary provincial participation in the negotiation and implementation of international agreements. The nature of Canada's executive federalism would make such an arrangement manageable in the negotiating stage. Provincial participation in agreements does, however, raise issues about the legal status of such agreements and their subsequent enforcement.

The recent history of issues involving the sale and distribution of alcoholic beverages illustrates the potential problem. During the Tokyo Round, the provinces made a voluntary statement of intent with regard to the sale of alcoholic beverages, agreeing to:

- Implement a nondiscriminatory listing policy.
- Eliminate preferences on spirits.
- Freeze the existing margin of preference on wines.

This statement was useful to the Canadian negotiators, particularly in discussions with the United States about the 'wine gallon assessment' that constituted a major impediment to the sales of bottled high-quality Canadian rye whisky.[4] It was also useful in negotiations with the European Community.

Like other pledges on the use of alcoholic beverages, however, this one has had an uncertain history of observance. Ontario introduced a handling charge for imported wines that it contended was based on higher costs. After extensive consultations with the federal government and foreign governments, Ontario withdrew the handling charge. In the course of these discussions, it had been suggested that some of the concessions Canada had obtained during the Tokyo Round might be withdrawn.

Two alternative inferences might be drawn from this experience. One could conclude that even the weakest form of voluntary agreement can have some effect on the behaviour of governments. The threat of retaliation can make a weak agreement self-enforcing. The opposite conclusion is that it is not worthwhile to attempt to involve provinces in international economic agreements. The federal government might be reluctant to enter into such agreements, and the value of the agreements might be discounted by Canada's trading partners.

Whichever alternative one accepts, it is clear that the difficulties posed by the Constitution and its interpretation to date, could place Canada at a disadvantage in future international negotiations.

THE SIGNIFICANCE OF DISPUTE-SETTLEMENT MECHANISMS

There appears to be a relationship between the potential for negotiation of international trade agreements and the subsequent viability of those agreements. This relationship seems to be of two kinds. One flows from the fact that the economic incentives that lead countries to negotiate trade agreements continue to operate once an agreement is implemented. Thus, if an agreement is negotiable, it should be self-enforcing.

Contingencies can arise, however, that are not foreseen when a contract is negotiated. When private parties enter into a contract, they rely upon the courts to interpret and enforce the agreement if events do not follow their expected course. As a rule, however, nation states guard their sovereignty jealously and are loathe to submit the interpretation and enforcement of an international agreement to adjudication by a supranational court. (There are exceptions – such as the European Court, which is emerging as an important institution in the European Community – but they prove the rule.) Thus, there is a reverse relationship between the negotiability and the viability of an agreement. Any uncertainty about its durability influences the prospects for successful negotiation. In other words, if an agreement is perceived as enforceable, it may be negotiable.

Some Canadians express concern that the United States might abrogate a bilateral agreement or use the threat of abrogation to pressure the Canadian government. This possibility is very unlikely. The argument ignores the pressure that the US government could exert on Canada under present arrangements. The simplest type of action for the US government would be to stop granting Canada special treatment. For example, in cases of import disruption under Article XIX of the GATT, the United States could simply apply global MFN quotas, instead of seeking voluntary export restraints with countries other than Canada as it did in the carbon steel case. A narrow sectoral arrangement that has a relatively short termination provision, such as the Auto Pact, would also be a candidate for pressure tactics.

A comprehensive bilateral trade agreement involving an FTA would be the arrangement most immune to abrogation by either country. It would engage the support of many interests in various industries in different parts of each country, creating durable coalitions on each side of the border that would support its continuation.

A much more serious concern is that the benefits of a bilateral agreement might be eroded through the cumulative effect of small deviations from its terms. Central to the viability and enforcement of any international agreement is its disputes-settlement mechanisms. This would be particularly true for a bilateral Canadian/US agreement.

The US/Israel free-trade agreement provides for the establishment of a joint committee to conduct consultations on bilateral free-trade issues and to resolve any disputes. Considering the importance to Canada of trade with the United States, we recommend a more comprehensive and legalistic disputes-settlement process in any Canadian/US free-trade agreement. A large and powerful country such as the United States can use political and economic pressures to obtain conformity with its views of an international agreement. A smaller, more trade-dependent country, such as Canada, benefits from the protection of a rule-oriented process under which there are equal opportunities to be heard and decisions based on the facts and rules are more assured (Sohn 1984, 21).[5]

The development of consistent findings by an arbitral tribunal, furthermore, is an important means of building trust between signatories and ensuring the continued viability of the agreement. And for federal systems such as those of Canada and the United States, the existence of an independent tribunal that provincial or state governments could take their complaints to would provide an escape valve for minor irritations, which could prevent the whole agreement from coming unglued.

Depending on the permanence of a free-trade agreement and the desired size of the bureaucracy created to maintain it, access to the tribunal by private citizens is something that should be considered. Although opening up the disputes-settlement process would raise costs, an international tribunal could provide an apolitical forum for diffusing protectionist sentiments. National governments could deflect complaints by referring them to an international tribunal that would give them an independent hearing.

We recommend adoption of a four-part mechanism for dispute resolution in a Canada/US free-trade agreement. A consultation obligation and a conciliation mechanism, providing for the appointment of a mediator if required, should be included for the resolution of political disputes between the two countries. For more specific political or technical disputes that involve provincial or state governments, provision could be made for arbitration by a single arbitrator acceptable to all parties or by an arbitration tribunal. Finally, provincial, state, or federal queries about the interpretation of a provision or the conformity of legislation to the agreement should be referred to a permanent, independent, rule-oriented international tribunal. This tribunal might also hear complaints from private citizens about, for instance, a provincial or state government's regulation of trucking or the importation and sale of liquor.

An effective dispute-settlement mechanism in a bilateral agreement would help allay Canadian concerns that the United States would exert economic and political pressure to bend the interpretation of the agreement. At the same time, it would allay US concerns that

Canadian provinces would derogate from their commitments.

A PLAN FOR ACTION

The most feasible option for effective Canadian participation in international trade negotiations is to continue to have voluntary provincial participation but to raise the level of political commitment. Given Canada's unique constitutional division of powers, an international agreement with such far-reaching implications for the Canadian polity as a bilateral free-trade agreement with the United States should not be concluded without a comprehensive federal-provincial agreement on all of the terms to be included in it.

A second option is for Canada to develop legal mechanisms to make provincial participation in international agreements enforceable in domestic law. This would require a constitutional amendment requiring provinces that had chosen to opt into an agreement to abide by their commitments. Such a measure would not involve the transfer of sovereignty (and political power) to the federal government that would occur if the Constitution were amended to give the federal government the authority to compel provincial compliance. But, although a measure making provincial participation permanent would alleviate problems of uncertainty in the enforcement of international agreements, it would be very difficult to obtain, given the stringency of the constitutional-amendment formula.

The negotiation of a Canada/US free-trade agreement could well be described as the most important decision that the Canadian government will have to make this century. It certainly rivals the bringing home of the Constitution as a significant political development for the future of Canada. If the provinces' participation is constitutionally required to implement the terms of such an agreement, surely their formal participation should be invited in the development of Canada's negotiating strategies. It is our view that nothing less than a series of first ministers' conferences, combined with a federal/provincial consultative mechanism[6] and resulting in the signing of a federal/provincial agreement on the terms of an FTA, would be required to insure implementation of and compliance with any FTA negotiated with the United States. Essentially the same approach would be needed for effective Canadian participation in plurilateral agreements regarding trade in services or trade-related investment issues.

At the same time, we argue that only one government, the government of Canada, should be and be seen to be negotiating and concluding an international trade agreement with another sovereign nation. A federal/provincial agreement could not be enforced in the courts, nor would it necessarily be binding on the activities of subsequent provincial or federal governments. However, after such a public display as a series of first ministers' conferences and the formality of provincial and federal governments' signing an accord, it would be difficult politically for a provincial (or federal) government to derogate from an agreement.

We do not believe that a federal/provincial agreement need necessarily have the approval of all the provinces. Most or indeed all might choose to participate, but requiring unanimity would give any one province an effective veto over the terms of the agreement. The significance of a federal/provincial agreement lies in its public and solemn demonstration of political will to carry out the details and intentions expressed in a Canada/US free-trade agreement. Canada consists of federal and provincial governments, sovereign in their own spheres. Any international agreement, such as an FTA with the United States or a plurilateral agreement for trade in selected services, that will result in limitations on the provinces' authority to regulate in certain areas cannot be implemented and maintained without a definite political commitment from them.

The difficulties of involving the provinces in the negotiation and implementation of international trade agreements may appear to be insuperable, but in some ways the relationship between the provinces and the federal government on these issues in Canada is analogous to the relationship between Congress and the president in the United States. Much experience has been accumulated in dealing with Congress; the fast-track procedure for granting negotiating authority and implementing trade agreements is an institutional innovation designed to avoid problems that have occurred in the past. Canadian governments will also need to be creative in developing co-operative approaches that will contribute to effective participation in international economic negotiations that are vital to the country's economic prospects.

The possibility of a provincial government's derogating from an international economic commitment may be a source of concern, but this problem is not unique to Canada. As a rule, it is not possible to bind the future actions of sovereign legislatures. An effective and impartial disputes-settlement process would help maintain an agreement. The key to sustaining a bilateral or multilateral economic agreement is that it engage a broad range of economic interests in diverse industries from various regions of the country.

NOTES

1. The material-injury test is applied to imports from countries that are signatories to the GATT Subsidies Code.
2. For some suggestions on these issues, see Lipsey and Smith (1985, chap. 8).
3. See *Canadian National Transportation Ltd. & Canadian National Railway Company* v. *AG Canada* (1984), 49 NR 241 (SCC) per Dickson, J. at p. 277; *MacDonald* v. *Vapor Canada*, [1977] 2 SCR 134 per Laskin C.J. at pp. 25-6.
4. The 'wine gallon assessment' method levied duties upon the volume of imported alcoholic beverages without regard for the alcoholic content. Thus, there was an incentive for Canadian whisky to be exported to the United States in overproof form; it was diluted with water and bottled on the other side of the border.
5. John Jackson has long been an active proponent of international rule-oriented dispute-resolution mechanisms in such articles as Jackson 1979; 1984.
6. This consultive mechanism could build on the experience with the office of the co-ordinator of the multilateral trade negotiations during the Tokyo Round.

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Discussion

QUESTION: Murray Smith said that one way for Canada to handle a trade agreement would be for the federal government to accept it by treaty and the provinces to accept it voluntarily. Would the US Congress accept an agreement that contained provisions that were only voluntarily accepted by somebody else? I have my doubts.

GARY HUFBAUER (Institute for International Economics): If the matter were stated in as stark a form as that, the answer is probably no. But most international trade agreements operate because of continuing mutual interest among the participating parties, not because of binding clauses.

I think Dr. Smith put his finger on another very important element – withdrawal provisions. If the potential for withdrawing concessions looked sufficiently balanced to the United States and to Canada, that would provide tremendous glue, even though some of the formal obligations might be slightly unequal.

JOHN JACKSON (University of Michigan Law School): I don't think I can add too much to that, except that I think Congress would be somewhat more concerned than Mr. Hufbauer about what he dismisses as legalities. But I can see all sorts of ways to design for this. For instance, I can see the Canadian federal government's getting all the provinces signed up before it signed a Canada/US treaty. Alternatively, I can see it getting two or three key provinces signed up with a 'best-efforts' commitment to get the rest signed up and some kind of withdrawal rights for the United States if the other provinces didn't sign within a stated period of time. I can imagine all sorts of rebalancing provisions of that type, lots of creative jurisprudence.

QUESTION: Compared to the United States, Canada has a lot of industries that are highly regulated, particularly in terms of export prices. I have in mind things like communications, electricity, airlines, finance, agriculture – a long list. How would the United States react in negotiations to this situation?

GARY HUFBAUER: In the first instance, the United States would attempt to persuade Canada that what we have done is good for us and better for you, so deregulate. But in the end there would probaby be a great deal of sympathy for the fact that deregulation is a long-term process. If the eventual target were set out, I think there would be considerable acceptance of the notion that Canada might reach that target on a much slower schedule than the United States would.

QUESTION: One of the questions that pervades the Canadian debate is the general category of what we call American nontariff barriers. If I understand the proposed US/Israeli agreement correctly, it includes a clear provision of no deviation from countervailing duties and antidumping legislation. We are slowly getting the impression that some nontariff barriers are negotiable and some just aren't, even for a free-trade agreement.

JOHN JACKSON: Well, I suppose insofar as negotiation is a process of each side's determining what its price is, everything is negotiable at some price. But that's not quite a practical answer.

I must say a lot of Americans wouldn't use the same terminology for some of what you call nontariff barriers. I'm trying to avoid getting into a five-hour lecture here, but the United States has a system that it thinks has resulted in more open market than that of virtually any other major industrial country in the world. The countervailing-duty processes and the antidumping processes are part of that system. They are an attempt to provide, in a depoliticized way, a shoot at the principle often called the level playing field. The level playing field is a distorted concept that has many fallacies, but it has proved fairly useful in keeping some overt protectionist pressures to a minimum.

The US Congress is really quite adamant in maintaining the basic structure; that is, countervailing duties will be used to offset foreign subsidies, and antidumping duties will be used to offset dumping. However, there's a lot of play in the joints because we are not entirely sure what is a subsidy that really should draw some kind of an international response. As I read the history of the Israeli treaty negotiation and as I read Congress in the last ten years, carving out an explicit exception to rules would be an uphill battle. It would be very difficult to get agreement that Canada shall not be subject to the countervailing duty-process, et cetera, et cetera. But that doesn't rule out the possiblity of looking interstitially at rather precise issues – for example, ought such or such a factor be countervailable? Additionally, attention could be given to some kind of a dispute-settlement mechanism, which might be a very effective way to give you slight additional leverage on the decision-making process in the future, to inject certain sound economic principles.

Incidentally, I was a little amused this morning when the speakers talked about subsidized exports for an hour and a half and nobody mentioned the GATT code or the US countervailing-duty law. The thought went through my head that if Congress witnessed this, you would probably lose about thirty votes for any bilateral trade agreement.

GARY HUFBAUER: I only have a few footnotes to add to that comment. I agree it would be an uphill battle to negotiate changes in the countervailing-duty or the antidumping law. The Israelis did not take on the countervailing-duty or the antidumping lobby. It wasn't that important to them; since Israel is a small trading partner, the injury test eliminates the great majority of potential cases. But the Israelis did take on the textile lobby, and they succeeded. If the countervail and antidumping laws are that important to Canadians, Canada might well make some inroads.

I should add that the interstitial approach is really the sensible way to seek reform. The causation and injury tests are so obscure that not twenty congressmen in a body of five hundred understand them. Then you get into truly obscure issues, such as cumulation. The whole notion of antidumping duties in a free-trade area makes very little sense. In most cases that would face Canada, there's lots of room to nibble away at objectionable provisions in the countervail and antidumping laws, provided it's done subtly.

I also come back to the point I made in my initial remarks: investment negotiation would take care of some US concerns, making much of the rest easier.

PETER LESLIE (Queen's University): A question for Murray Smith. If I heard you correctly, you said you found it difficult to imagine bilateral enforcement of an agreement because of the asymmetry of the two countries, but you also said the arrangement should be distinct from an arbitration arrangement. Do you mean that there should be recourse to a third party or an organization such as the GATT? What did you have in mind?

MURRAY SMITH (C.D. Howe Institute): I was trying to distinguish between a process for settling disputes between two sovereign states and a judicial process. The extreme case of the latter is the supranational institutions of the European Economic Community. For example, the EEC has regulations about permitted subsidies. Then there's a judicial process to decide whether a particular subsidy is acceptable; if the European Commission decides it's not, then the matter goes to the European Court. I was contrasting the process of trying to arbitrate or interpret a particular agreement with a process using a commission that could simply decide what subsidy practices, by all parties concerned, including the Canadian provinces and the US states, were acceptable. I was trying to keep the process very open-ended and to avoid raising all those sovereignty issues.

In some areas, you might want recourse to something like the GATT dispute-settlement process. I think it was very useful in the FIRA case, primarily because the process is so cumbersome and slow that it diffused the issue. But I also think there's scope for innovation in this area. Perhaps I can get Professor Jackson to comment here.

JOHN JACKSON: I think one of the most important parts of a bilateral treaty of the type we have been talking about could be a dispute-settlement mechanism that is somewhat better constructed than those available in other forums. The GATT mechanism leaves a great deal to be desired. The US/Israeli agreement has a new dispute-settlement provision; you would want to look at it, but I am not sanguine that it's particularly good either. One of its problems is that it permits, at some point, an appeal to the GATT process, and then you could get mired in the GATT process again.

Overall, I think the question of a dispute-settlement mechanism bears a lot of attention because it's central to an arrangement of this type.

QUESTION: What kind of time frame are we talking about here?

GARY HUFBAUER: Even bilateral negotiations can take a long time. Of course, you could have negotiations to set out some principles and then subsequent negotiations to fill in the details – that's the process contemplated for trade in services in the US/Israeli agreement. But if an agreement is going to be an ambitious undertaking, especially if it's going to involve the states and the provinces, it will take a long time. And a multilateral agreement would take longer.

JOHN JACKSON: I just want to point out that the authority for the fast-track procedure ends 3 January 1988. But I don't think Canada should deem it an overwhelming deadline. First, if the multilateral trade negotiations get going, the Congress may well extend the deadline. If it did, you could piggy-back on that extension. Second, as I was hinting, the convergence of the fast-track procedure with normal congressional procedures is such that simply going for a regular statute, without the fast track, might be adequate if you had your political bases covered.

QUESTION: Is it feasible to look for completed negotiations within this window of opportunity that people are talking about?

JOHN JACKSON: I am dubious myself.

Trade policy options in perspective

Simon S. Reisman

The conference agenda tells you that the subject of my remarks will be Canadian trade agreements in historical perspective. I have made available a paper on this subject that I prepared recently for the Brookings Institution (Reisman 1984). It is worth a leisurely read because it bears on the trade issues under discussion at these meetings. But I don't think that talking about history today would make the best use of your time or mine. The most helpful thing I can do here is to give you a view on what Canada should be doing now and in the immediate future to advance our trade interests. I will, of course, be drawing on the lessons of history, but in the main I will base my remarks on my own experience as a trade advisor and trade negotiator.

I am no longer a public servant, and I have no employer constraints or special interests to serve. I am free, therefore, to be as bold and provocative as I want to be – and as Canada's economic dilemma demands. I know that you have had more than a full quota of papers and speeches in the past day or two, but I promise that in return for a half-hour of your attention I will give you a few interesting ideas to think about.

THE HISTORICAL FRAMEWORK

First, a few lessons from history.

– From colonial days, Canadians have been fascinated by the opportunities for profit to be found selling into the vast, rich, market of the United States. Our people saw – without the help of economics,

Mr Reisman is chairman of the board, Reisman and Grandy Ltd., Ottawa.

research, or theories – that an open trade door to the US market would help to overcome the fundamental weakness of a small, widely dispersed home market. This is why trade reciprocity with the United States has been such a recurrent theme in Canadian political and economic history.

– With very few exceptions, the United States has been indifferent to the idea of reciprocal free trade. With their own continental market and much less dependence on foreign trade than Canadians, Americans have usually turned their minds to other, higher priorities. There never was as much in it economically for them as for us. On those occasions when the United States did get interested in free trade with Canada, there were considerations in play that went well beyond the calculus of economics or the profits to be made from trade. The successful negotiation of the 1854 Reciprocity Treaty and its rude abrogation in 1866 confirm the importance of nontrade issues in making and breaking trade agreements with the United States. In American minds, if not in ours, trade issues have always been linked to other issues to a greater or lesser degree.

– Canadian interest in a reciprocal trade deal with the United States has traditionally peaked during periods of economic crisis or at times when we suffered setbacks in our relationships with trading partners overseas. In contrast, the United States has usually turned inwards and raised trade barriers in the face of hard times. Consequently, in the search for mutually beneficial trade arrangements between Canada and the United States, there has often been a mismatch of goals and interests.

– John A. MacDonald's National Policy of 1879, with its strongly protectionist orientation, was in large part a reaction to US indifference to Canadian efforts to negotiate a broad agreement for free trade. The National Policy was a drastic reversal of the commercial regime under which the British North American colonies had developed. A frankly protectionist approach became a major force, influencing the economic development and industrial structure of the country Confederation had created. The main lines of the restrictive trade system then introduced have never since been basically altered.

– In the years following the introduction of the National Policy, new and vocal domestic industries and special-interest groups heavily dependent on tariff protection draped themselves in the flag of nationalism at home and the flag of imperial Britain abroad to defeat the export-oriented industries that continued to yearn for freer trade with the United States.

- In spite of the restrictive trade policies practised in both countries, which have varied in intensity as economic circumstances changed, massive trade movements have continued across the Canadian/US border. The strong, natural economic forces that flow from the physical sharing of a continent and the extensive social and cultural intercourse that they have engendered have combined to raise the trade in goods and services between Canada and the United States to a higher level than that between any other two countries. Nonetheless, this trade has developed under terms and conditions that denied to both countries, particularly to Canada, many of the benefits that might be expected to flow from a more open trading system.

- Periodic efforts by Canada to break the shackles imposed by a small home market and overdependence on the US market – for example, the Diefenbaker 15-per-cent trade diversion to the Commonwealth, the Sharp 'third option' with Europe, and more recently the Pacific Rim and Third World options – have all met with failure or very limited success. The reality seems to be that there is no viable alternative to the US market if we aspire to world-class industries capable of competing in world-class markets. At least, that's what history appears to tell us.

THE POTENTIAL FOR ECONOMIC GAINS

I do not intend to take the time today to argue the case for free trade. There are few subjects of economic policy that have been examined more frequently or more thoroughly in the world context or in the Canadian context. The findings are clear and unequivocal. There can be no disputing the rigorous logic of economic theory or the hard facts of economic experience:

- With very few and highly limited exceptions, protection is costly in economic terms.

- The removal of trade barriers yields economic benefits.

These facts are universally true and particularly significant for advanced industrial countries such as the United States and Canada. If there continues to be legitimate *economic* debate about free trade, it is about the size of gains, the time sequence for the realization of benefits, and the pain and costs of the adjustment process.

Usually the debate is not about economic consequences but about matters in the political and social realm – such lofty issues as sovereignty and independence, national and cultural integrity. Unfortunately, these aspects of the subject do not lend themselves to the analysis of hard facts, and more often than not the debate degenerates into statements of dogma, emotion, and rhetoric. I will have more to say about this before I complete my remarks. But I will acknowledge now that in this realm there can be no proof positive on either side of the argument.

Given the basic thesis that there are economic gains to be made by the removal of trade barriers, the question remains as to how significant these gains would be for Canada. Is the game worth the candle? Here too the subject has been worked over extensively over the years. It has been examined by numerous professionals in government, the universities, and research organizations in the past decade alone. The results are clear, if not precise. The gains would be large after the initial adjustments.

Canada and the United States have always had a substantial differential in real income per capita, although it has narrowed in the past two decades. The causes of the differential are deeply rooted in the fundamentals of geography, population, institutions, and stage of economic development. Moreover, protectionist policy has created in Canada an industrial structure that, except for the large resource-export industries, has a much lower productivity than that of the United States. Productivity in Canadian manufacturing is the major area of weakness. Work done for the Gordon Royal Commission by Dr. John H. Young some thirty years ago and updated in recent years by others leads me to the estimate that something like ten percentage points of the differential in per capita income would be removed over time if Canada had unqualified access to the US market as part of a free-trade arrangement. That would come to some 40 billion each and every year after the industrial restructuring process had been completed. It is hard to come up with alternative policies whose potential benefits for our people would come close to even half that figure.

ALTERNATIVE TRADE POLICIES

Alternative trade policies may be open to us. World free trade is, theoretically at least, more attractive than a bilateral free-trade agreement. But at present, any such scheme involving the free world is simply utopian and not worthy of the attention of practical people. The opposite extreme – reverting to a full import-displacing policy of trade restrictions – would condemn Canada to a backwater economy of decline and stagnation, a falling standard of living, and rising unemployment.

What about the alternative of continuing along the present path of gradual reductions in tariffs and other restrictions under the umbrella of the General Agreement on Tariffs and Trade (GATT)? This approach, after all, has served us reasonably well since the Second World War. Why take the risks associated with a major break in policy? Why make, as Donald Macdonald has been quoted as saying, a leap of faith?

I believe that the GATT approach *by itself* has seen its course as far as serving Canadian trade interests is concerned. A case can be made (indeed has been made) that the trading framework of the post-Tokyo Round of GATT agreements gives Canada the worst of both worlds. On the one hand, our tariffs are too low to protect the home market. On the other hand, our access to the US and world markets remains precarious. The remaining barriers – tariffs and others – together with the whole panoply of escape clauses and emergency measures allowed under the GATT deny Canada the assured access to the US and world markets needed to put in train the large investments required to restructure our industries so they can meet world-class competition. The emergence of trade blocs, the relentless sweep of new technology, the limited negotiating scope left for Canada at present levels, the more frequent resort to and threat of escape-clause actions, and the danger of a new wave of protectionism engendered by exchange-rate instability suggest that a policy based on reliance on GATT alone will become increasingly difficult to sustain. When we add to this the hard fact that we can no longer count on our resource industries to yield the economic rents that in the past have allowed us to enjoy economic growth and high standards of living despite rather regressive trade, investment, and other economic policies, the need for a new approach becomes even more compelling.

Whether Canadians like it or not, the harsh truth is that the only real option available to us today is to try to reach a bilateral free-trade arrangement with the United States to cover all or virtually all the goods and services we produce. (I have chosen not to discuss sectoral free trade because I do not believe it to be practical. Even if we could advance along the sectoral route, despite all its inherent weaknesses and contradictions, such a move would not solve Canada's economic dilemma because it would not offer adequate opportunities to break out of our low-productivity industries on a broad front. In any event, both the Canadian and the US governments seem to have abandoned the sectoral approach as a serious option.)

POTENTIAL RISKS OF A FREE-TRADE AGREEMENT

The option of a comprehensive free-trade agreement with the United States, even if that country were willing to enter one, has, of course, high risks of its own. How many of the potential benefits from free trade we would actually get and how quickly we would get them would depend a great deal on what kind of an agreement Canada could negotiate. No less important, the ability of a government to muster the public support needed to embark upon a risky initiative of this magnitude would depend on whether the United States would be willing to accept terms and conditions that recognized the essential asymmetry of economic and industrial positions. Special features to anticipate and deal with the risks would be especially important during the transitional period, when Canadian business would be gearing up to exploit the new opportunities and to meet the new competitive challenges.

Let us consider some of these risks, actual and perceived, and see how much they might reasonably be overcome or reduced in the negotiating process.

Keep in mind that the observations offered here concern a free-trade-area agreement that would meet the requirements of GATT – that is, one that would apply to substantially all the trade between the two countries and that would be fully in effect after a firm transitional period. We are not talking about an economic union or a customs union, which would raise quite a different range of issues.

Sociopolitical concerns

Before examining the economic aspects of Canada/US free trade – the benefits and risks – I would like to turn for a moment to the non-economic aspects – the political and social issues – that have always figured so prominently in the debate.

Let me acknowledge immediately that I do not feel comfortable in this noneconomic area because it is so extremely difficult to pin down the basis for the concerns in factual or analytical terms. It is even more difficult to test the arguments in a rational, objective manner because they often take the form of dogmatic statements of belief with a high emotional content.

As I understand it, people who worry about this side of things argue that free trade with the United States would lead to a loss of Canadian sovereignty, to the subversion of our cultural independence, to the undermining of our ability to set our own goals and policies, and ultimately to the disappearance of Canada as a separate nation. Although these arguments are usually advanced by people who believe that the economic consequences would also be adverse, others accept that free trade would have economic advantages for Canada but worry that our ability and desire to behave independently would be severely eroded.

Frankly, I have not been able to find convincing evidence to support these contentions, although I have tried over many years to follow the debate. It is not easy to penetrate the emotion, the dogma, the doctrine, and at times the fervent religiosity that permeates the discussion. I have not been able to discover a basis for these views in theory, logic, analysis, history, or precedent. You either believe or you don't.

Since I do not know how to advance this aspect of the debate, I will not try today to review the arguments. But I will refer you to studies by well-known professionals in the field. First, there is the study by Peyton Lyon prepared for the Economic Council of Canada in 1975, which deals with the issue in an orderly and thorough manner. I also refer you to the work of Richard Lipsey and Murray Smith (1985) prepared for the C.D. Howe Institute this year; the authors make a simple, direct, and logical presentation. I agree with the conclusions of both these studies.

These analysts believe, as I do, that free trade would present very few threats to independence that we don't already have to worry about. Of course, we live in an interdependent world. Of course, there are limits on how far we can exercise our full sovereignty when we are dependent on others and they are dependent on us. Indeed, I believe that we could worry less about our freedom of action if we codified our bilateral rights so that we would not have to complain and implore so frequently when they are threatened.

Let me add a note from my own experience. I have fought in the trenches of the trade battles – five rounds of tariff negotiations, the automotive agreement, two rounds of surcharges, the Smithsonian meetings, the discussions on the floating exchange rate, and many others. I have no doubt that we can hold our own, despite our great vulnerability. I also have no doubt that the stronger we are economically, the more confident and independent we can be in the posture we strike in our relations with the United States and with others.

Economic risks

Inability to adjust

A few words about the economic risks for Canada in a free-trade agreement. The one cited most often and strongly is that many of our manufacturing industries are structured to serve the relatively small Canadian market and, therefore, do not have the plant, equipment, technology, personnel, management, experience, or connections to withstand unprotected competition from abroad or the ability to take advantage of the larger continental market.

There is no question that a few US industries do have this kind of edge on the Canadian competition. The logical approach to this problem would be to include in an agreement transitional measures to allow the weaker partner time to upgrade. It might also be necessary to provide adjustment assistance for a period. This technique was built into the Auto Pact and enjoyed a good reception and a considerable measure of success.

Moreover, many Canadian industries and business leaders – far more than a few decades ago – express confidence in their ability to survive and flourish in a North American free-trade environment. There is still resistance from some of the older industries, such as textiles, clothing, footwear, furniture, and a few others that continue to enjoy considerable tariff protection and other forms of assistance. Surprisingly, however, even in these traditionally protected industries, one can find numerous examples of Canadian firms that have been able to find a profitable niche in the export market – usually in the United States for a novel or specialized product. In other cases, government assistance may be required to encourage firms into new lines or endeavour.

Some of these industries are in trouble now and may not survive, even with substantial protection. But enterprising firms, even in this group, would have better prospects of survival in an environment of change with new markets being opened up under the free-trade regime.

There is a growing body of research on the adjustment costs associated with the reduction and removal of protection, both in Canada and elsewhere. Much of this is based on actual experience. The evidence appears to show that the problem of adjustment costs has been grossly exaggerated.

The loss of foreign-owned enterprises

Another perceived risk relates to the fact that many Canadian enterprises are foreign owned and were established here to get behind the tariff wall. With free trade, it is feared, they would pick up and go home. In recent years, we have seen some such enterprises close down, despite continued protection, because scale and technology had made their investment in Canada unprofitable. Under free trade, small and antiquated concerns that were either unable or unwilling to upgrade and adapt might indeed go under. This would also happen to Canadian-owned enterprises, as it has up to now.

There are many reasons other than protection for locating in Canada, as is evident from the record in industries for which the tariff is zero or very low. It is difficult to see why companies that are profitable and have a substantial stake and experience operating in Canada would choose to close down. On the contrary, good business sense suggests that new opportunities opened up by easier and assured access to the US market would encourage them to expand and adapt to the new challenges and opportunities.

What would likely occur would be changes in product mix, more specialization, longer runs, and increases in scale. World-mandating for select products would become a more common practice, and we would likely see mergers and takeovers as the more energetic and enterprising firms responded to market opportunities. Indeed, this kind of rationalization of output is the way a country reaps the benefits from free trade and becomes more productive. Far from being regarded as a problem, such developments should be welcomed and encouraged.

The possibility of abrogation

There are important risks related to decisions on where to locate.

Many of these risks, which are less likely to influence firms experienced in doing business in Canada than new enterprises or those embarking on major new investments, are rooted in uncertainty about the terms of access to the US market. Any doubts about the permanence of the free-trade arrangements or the likelihood of the application of nontariff barriers or emergency trade restrictions would clearly favour locating in the larger of the two markets. Notice that this risk, which applies to both foreign-owned and domestic enterprises, is not unique to a free-trade situation. It is now and always has been a risk for enterprises that sell into export markets from a Canadian base, whatever the prevailing level of protection. It would simply become more critical in a free-trade environment, where the essence of the business plan is to organize specifically to serve export markets.

This concern is by no means hollow, nor is it an adequate answer to observe that there have not been many cases in which barriers have actually been imposed pursuant to pressures for special or emergency protection. The threat posed by an investigation under, say, the countervailing law or a request for temporary relief under the disruptive trade clause permitted by GATT may be sufficient to deter an investment in Canada or divert it to a location in the United States. From my own experience, I can provide examples of cases in which uncertainty about access has had a determining influence on key investment decisions that have been very costly to Canadian economic development.

A firm cannot be faulted if prudence dictates locating and investing in the larger and hence safer of the two markets. It is not hard to see how serious a worry this would be in a free-trade environment in which Canadian industry would be expected to restructure in order to serve the US market. The benefits Canada could anticipate from free trade would be scaled down considerably if an effective solution could not be found to this problem.

There is no easy or complete answer to the risks for Canada arising from the possibility of abrogation of a free-trade agreement or from significant breaches in its terms as political convenience requires from time to time. There would, of course, be risks for the United States as well, since our record in matters of trade restrictions is not without blemish. The truth of the matter, however, is that if the United States became dissatisfied with such an arrangement it could walk away without suffering irreparable damage. For Canada, the consequences of such an eventuality would be very serious indeed.

To some extent, the agreement could be cast in a manner that would reduce these risks. A first requirement would be that the instrument of agreement have the highest possible level of legal and political commitment; it should probably be a formal treaty ratified by Congress in the United States and a parliamentary statute in Canada. Second, there would have to be provision for a long period of notice before any changes could be sought and an even longer period before any could be made. And amendments or modifications should require the consent of both sides at a level of legal and political commitment identical to that given the original agreement.

The agreement would provide for each country to give full national treatment of the goods, services, and enterprises of the other – that is, treatment identical to that accorded its own goods, services, and enterprises. There would be virtually no exceptions, and the few that were agreed upon would disappear after a firm transitional period. Departures from the agreement would require a formal amendment, and any such amendment involving a restraint on trade would be subject to a terminal date. There would be provision for awarding an injured party compensation judged by a neutral party to be equivalent to the damage suffered. Consideration might be given to an appropriate insurance scheme to remove or reduce the risks of trade and investment damage (see Reisman 1984, 49-50).

Could an agreement be designed to ensure adequate permanence and stability to the arrangement? In theory, yes. As a practical matter, probably not unless its substance, as distinct from its formal provisions, contained elements that made the continuation and nonimpairment of the agreement as vital to the United States as it would obviously be to Canada.

CANADIAN AND US ATTITUDES TOWARDS FREE TRADE TODAY

Of the mood in the two countries on the subject of free trade, I am prepared to say that today there is a greater willingness to consider this option than we have seen since the Second World War, not excluding the aborted effort of 1947-8, when the negotiations were at the government level and never got into the realm of public awareness and debate.

The discussion and the emerging attitudes in the two countries seem to be following the pattern of earlier history. The Canadian economy is not in good shape, and the forecasts say that things are not likely to get much better over the next several years. Thinking Canadians in business, the professions, and government are looking for a way out of the economic dilemma that we find ourselves in. They see tapping the vast, rich US market as a possible solution for our high unemployment, slow growth, and relative weakening in productivity performance and competitive position. In the United States, there seems to be a new-found confidence based on good economic performance, a strong currency, and a revival in its international, political, and defence leadership. As in the past, these are conditions under which the United States is willing to look outward and take some risks.

Although many Canadians would be willing to grasp the nettle, the thought of a major trade move still causes a good deal of apprehension, especially among the weaker industries in Ontario and to a lesser degree in Quebec. This, of course, is reflected in an understandable nervousness among politicians, especially given a new government in Ottawa, a change in leadership in Ontario, and political instability in Quebec. If an agreement could be structured that took Canadian risks into account, that provided an adequate transitional period, reasonable assurances against abrogation, security against nontariff barriers, and that contained assurances against capricious threats of restrictions (such as we experienced recently for steel, lumber, fish, pork, and manufactured food, and other goods), the chances of strong Canadian support for an early move to free trade would be much improved.

Would the United States be willing to go the extra mile in recognizing Canadian sensitivities, to accept arrangements that were in some respects asymmetrical as to timing, exceptions, government assistance, and other features so as to encourage restructuring in Canada?

We will never know, of course, unless we try, unless we see what we can achieve through negotiations. A major difficulty, I fear, is that the economic benefits from free trade are likely to be asymmetrical. US industries already have their mass market, and the potential gains from new investment and improved productivity are certain to be less impressive for the United States than for Canada. Thus, Americans would, I suspect, have to see concrete benefits in other areas, if they were to accept the terms and conditions that Canadians would justifiably request in negotiations.

A PROPOSAL FOR AN INCENTIVE

It is this need to find some major attractions for the US side that leads me to a rather bold and controversial proposal. Given the extreme sensitivity of the subject I am about to raise, some of you may think that I have taken complete leave of my senses. But I am willing to take that risk. Perhaps the proposal will help move the debate forward. Certainly, it will heat it up!

The subject is water. For some years, a group of Canadian engineers led by Thomas W. Kierans of Newfoundland have been developing the concept of harnessing the flow of fresh water into James Bay to provide a new, large, reliable, and renewable source to meet the requirements of both Canada and the United States. This is fresh water that becomes salt water as it flows through James Bay into Hudson Bay and from there into the Arctic and Atlantic oceans. It is totally wasted for fresh water use.

Exploratory engineering studies on this project have been presented and discussed at conferences in both countries in recent years. What has become known as the Grand Canal Project would entail the conversion of James Bay from a salt-water body to a fresh-water lake by means of a sea-level dyke across the mouth of the bay. The fresh water pouring into James Bay from some twenty rivers would be fed into the Great Lakes–St. Lawrence water basin through the Grand Canal system, which would consist of a series of canals, dams, pumping stations, and underground water tunnels and make use of northern rivers as well as the Ottawa and the French river systems.

The Grand Canal Company, under its president, Tom Kierans, is actively promoting the project and in co-operation with several reputable engineering companies is at present embarking upon feasibility studies covering the whole range of engineering, environmental, and economic issues involved. I am personally associated with the ongoing work of the company, advising on the economic studies.

Let me give you some idea of the dimensions of this project. It would move into Lake Huron an amount of fresh water equivalent to twice the present flow of the Great Lakes system. Once in the Great Lakes, it would be available to stabilize water levels in that system.

The bulk of the water would be available for transfer through a North American grid to Western Canada and to the midwestern and other parts of the United States where fresh water is becoming increasingly scarce. No technological problems are anticipated, given the proven experience of similar projects, particularly that of California in recent years.

The magnitude of the Grand Canal Project would be some five times the size of the Apollo moon-landing project, roughly $100 billion in current dollars. It would take ten years to construct and put into operation.

The potential benefits for Canada

The urgent need for fresh water in the United States would, I believe, make that country an eager and receptive partner. Canada would be in a very strong bargaining position for obvious reasons. If the studies confirm, as I believe they will, that this project makes good sense for Canada in terms of all our interests and concerns, including environmental concerns, I am satisfied that we would be able to reap enormous economical benefits for this country.

First, the construction of the project itself would produce for Canada about 150,000 direct jobs and at least as many again indirect jobs all over the country to supply goods and services at all levels of sophistication to support this mammoth undertaking. It does not take much imagination to visualize the array of machinery, equipment, vehicles, steel, cement, lumber, pumps, turbines, and fuel and the whole range of engineering, financial, and other services that would be required for this project.

Second, the finished project would have ongoing benefits for Canada. It would make available ample fresh water for our arid regions. It would contribute effective flood control not only in the Great Lakes region but over the whole geographical area served by the new water grid. It would provide an immense number of opportunities for the native people who now inhabit the James Bay region; they could participate in the construction as well as in the continued operation of the project.

Third, the owners of the resource would earn substantial economic rents. It is expected that the price to be obtained for the new water would more than pay for the capital outlay and operating costs.

Finally and to my way of thinking most importantly, the project would provide bargaining leverage to Canada, which would own the water and be in a position to control its use.

As you might guess from what I said earlier, I believe that this project could provide the key to a free-trade agreement with the United States containing terms and conditions that would meet many of the Canadian concerns about transition and stability.

I believe we could negotiate a partnership with the United States that included the following terms and conditions:

- Virtually all the required capital to come from the United States.
- A good price for the water at its full commodity value.
- A commitment by the United States to clean up acid rain.
- A firm undertaking that all or virtually all Canadian goods and services would have immediate free access to the US market unencumbered by tariffs, nontariff barriers, emergency import restrictions, or any other impediment. Canada would have a ten-year transitional period to organize its industries to compete in the continental market, after which the agreement would become fully reciprocal.

Let me say quickly that in terms of benefits for Canada, the water project should be viable on its own merits, just as free trade would be viable on its own merits. Properly handled, the two can be made to reinforce each other. Apart from the trade possibilities, the benefits attendant on the megaproject would make a significant contribution to overcoming our economic problems for many years to come. If we had the imagination to link it to our trade objectives, it could put us on a course of economic growth and development that would assure us of full employment and a rising standard of living for the indefinite future.

Water has figured prominently in our relationship with the United States throughout our history. Perhaps no other subject in our national affairs arouses as much emotion, controversy, dogma, and prejudice. Perhaps no other resource holds as much promise for our economic future, or as much danger if we do not use it in a timely and just manner. Do we have the flexibility to approach this subject with open minds, free from preconceived ideas and the prejudices of the past? Do we have the courage and the imagination – yes, the audacity – to take on these two big projects, free trade and fresh-water sharing, at the same time?

I have personally suggested these ideas to leaders in government and business on both sides of the border, and I have been greatly heartened by the initial response. Americans are fully aware how sensitive both issues are in the Canadian scheme of things and would not take the initiative. Any proposals would have to come from Canada.

For my part, I feel confident that working out an agreement for free trade and water-sharing would be a good thing for both countries and would set a good example for the world. It would make us richer. It would also make us better neighbours because it would remove many of the frictions that have induced squabbling for years. It would not weaken Canadian sovereignty or our ability and resolve to exercise our independence. Indeed, it would enrich us, raise our confidence, and strengthen our will and ability to grow and to contribute to the world as a strong and free nation.

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Discussion

QUESTION: Two things bother me about what you have said. One is the assumption that the United States will soon be short of water. I think you are at least ten years ahead of yourself. Second, your argument gives me a sense of déjà vu. Every one of the items you raised has been raised before, though without the free-trade connection.

SIMON REISMAN (Reisman and Grandy Limited): I think there is a gap here – a gap in your imagination. Comparing water with any of our other natural resources is simply losing the sense both of the size of this concept and of the fresh-water situation in the United States. I would go so far as to say that water is the United States' most significant problem next to the nuclear problem in defence.

You talk about déjà vu. Well, maybe you've seen a great deal. But when you suggest that you don't see the Americans' being interested in this project, I'm amazed. I can tell you that discussions with two or three of the leading figures in the United States who used to be involved in the State Department with trade issues and are now with the Brookings Institution lead me to believe that the Americans would be interested. If there's a problem, it's not going to be in the United States – it's going to be in Canada. It's not easy to overcome past prejudices. Of course, this proposal will have to have a full-scale environmental examination, but I believe the project will prove positive from an environmental point of view as from others.

I want you to let your imagination roll a bit. Don't compare this project with other things that are really mice alongside elephants.

KLAUS STEGEMANN (Queen's University): On a practical point, how would you link the two treaties? Would you have one treaty that says give us free trade and we open the tap? If you do that, I think it would take a long time to build a functional system. To get free trade soon, the price that the United States is supposed to pay would have to be up front. Further, would you threaten to turn off the tap if the United States reimposed restrictions on Canadian exports?

SIMON REISMAN: I am tempted to reply to that question by saying don't bother me with details. But I won't do that because clearly there would be some very complex negotiating problems. For example, the need for water in the United States is not uniform across the country. Some of the people who would be expected to pay the price in trade and other respects are not the people who would get the benefits. So there would be huge problems of that kind. Huge problems are not the sort of thing that deter or limit people who really understand the significance of this issue.

The United States is going to have to address its water problem. We Canadians need to have the wit, the imagination, the foresight, and the broadmindedness to know that they cannot sit on this pool of our most valuable resource and say to the United States, we don't care about your problem. The fact is that countries look after their national interests to the extent that they are capable of doing so and when the devil drives, watch out. Sooner or later the United States is going to go after our water. So we don't have forever to resolve the issue in a manner that will meet our requirements.

The question of linkage isn't a real one because once the United States is committed, it's committed. The amount of water involved is immense, and the project would have to be developed in stages. The amounts of water that would flow – and I hope we would have a good say about that – could be handled so that progress is made on the trade side as progress is made on the water side. We would try to handle them in such a way that confidence began to develop in the stability of the arrangements around both of them.

If you want to look for problems, there is no end to what you can find associated with the negotiating and other aspects of concepts of this magnitude. But we are big boys, big countries. We do a lot of important things, and we do a lot of them together. I think we can handle the problems.

PETER LESLIE (Queen's University): I'm deliberately going to avoid the emotive questions that can be raised in relation to your proposal. But I want to ask if you have considered an aspect that I think very important. Whether we're talking about minerals or water, I'm concerned about the impact on our exchange rate of any kind of arrangement that involves enormous exports of products that have a very small labour component. That would vastly inflate the value of the Canadian dollar, making it difficult for our manufacturing industries to compete with the United States or with anybody else.

SIMON REISMAN: This project would doubtless raise adjustment problems in all sorts of areas. We have some studies going right now, and one of the critical areas we are looking at is that of effects on the balance of payments, exchange rates, and interest rates. It's not that we think these effects would be so formidable that they couldn't be dealt with. But they have to be addressed, and the offsetting or adjusting mechanisms have to be introduced to deal with them.

QUESTION: We know that the Americans are usually good at responding to price signals, and we know that commodities that are seriously undervalued tend to get overused and even wasted. I assume part of your list of conditions would be a price for the water at its full commodity value. Do you have any sense of the extent to which Americans undervalue water in relation to the price you have in mind? And what would such a price do to future scarcity and, therefore, to the attractiveness of the offer?

SIMON REISMAN: As for the attractiveness of the offer, even if Americans were to engage in good conservation practices – which they are not doing at the moment – the United States is rapidly getting itself into a position in which it doesn't have a lot of choice. Clearly, the prices we talk about would have to be realistic in terms of the cost of producing the water and of the uses to which it would be put. The experience of similar projects elsewhere, in particular that of a very large project in California (where they continue to treat water in some respects as a free good rather than a commodity), indicates that the price the user would be expected to pay would not be out of line with the product to which it would be applied. But these things will have to be proven.

QUESTION: Since the water resources are owned by the provinces, the payments would presumably flow there to Quebec and Ontario, to a large extent. That would in some way compensate for the industrial adjustment that this kind of scheme would necessitate. But M. Bourassa is proposing some other ideas for James Bay water, including using it for the generation of electricity, which could be sold as a value-added resource.

SIMON REISMAN: I'm glad you mentioned M. Bourassa, because I had intended to. He has just produced a book, which, incidentially, he is unveiling in Washington today. A chapter of it deals with the Grand Canal project, and he supports it. There is nothing inconsistent about using the same rivers for power and for fresh water. In fact, the two uses would reinforce each other since running the pumps and the system required for this new grid would take a lot of power.

PART VI: CONCLUSION

The future of the international trading system

Richard N. Cooper

A thoughtful consideration of Canada's options in its future trading arrangements should take into account the directions that international trade is taking as well as the likely future actions of its major trading partners. Although prophesying future economic and policy developments is an exercise that is not notable for its outstanding successes, some assumptions about the future can provide a starting point; a simple extrapolation of present circumstances has often proven a worse prophecy than could have been achieved with even a little thought about how the future might differ from the present.

It is in this spirit that I will address four aspects of the future trading system. First, what will be the economic environment in which firms engage in trade? Second, what policies will governments take towards their economies, especially towards the structure of production? Third, what will be the policies of governments towards the policies of other governments with respect to the structure of production? And fourth, what will be government policies towards the trading system itself? I will conclude with several observations on problems of the international trading system at the present time.

A GLIMPSE OF THE FUTURE

How far should we look into the future? It is worth noting the extremely long gestation period for major internationally agreed-on changes in trade policies. The Kennedy Round of negotiations under

Dr Cooper is Boas Professor of International Economics, Harvard University.

the General Agreement on Tariffs and Trade (GATT) was launched in 1962, concluded in 1967, and allowed for an eight-year transition period for the tariff reductions to take effect. It presumably took some further time for countries, industries, and firms to adjust fully to those tariff reductions.

The Tokyo Round of trade negotiations was launched in 1973 and concluded in 1979; the last tariff reductions agreed to there will not take place until 1987. To this schedule must be added several more years for full adjustment. So when we speak now about a new round of trade negotiations, we are really addressing the trading arrangements that will be in place fifteen to twenty years from now. If history is any guide, negotiations launched in 1986, as currently proposed by Canada, Japan, and the United States, after allowing for passage of authorizing legislation, negotiation, and a transition period, would pertain to the trading environment in the twenty-first century.

Technology

What will international trade look like in the year 2000 or 2005? Several technological developments will have a strong influence. After discussing them, I will make some observations on countertrade, which I suspect will be less prevalent then than now.

Computation, telecommunications, transport, and culture

There will be dramatic reductions in the costs of computation and of long-distance telecommunications and less dramatic but still significant reductions in the costs of long-distance air transportation.

The costs of computation have declined about 90 per cent in each of the past two decades; there are enough promising avenues under current research and development to suggest that this trend will continue for the next two decades. Taken literally, this projection suggests that the costs of computation in 2005 will be about 1 per cent of today's costs. Much high-speed computation will be virtually free by historical standards.

Recent declines in the costs of long-distance communication have been less dramatic only by comparison. Again, there is sufficient technological progress currently in the R&D pipeline – fibre optics are an example – to suggest further substantial declines in the costs of telecommunication.

In 1984 almost one-fourth – 24 per cent – of US exports by value were carried by air, as were 15 per cent of its imports. These figures were up from 8 and 6 per cent, respectively, in 1965. The relative growth of air cargo can be expected to continue since improved fuel efficiency of aircraft engines and, especially, increased carrying efficiency of aircraft will result in reductions in the costs of air transportation. The improvements look to come from substituting electronic and optical controls for the present electromechanical controls, from substituting strong but lightweight composite materials for many metal parts of aircraft, and from improved air-traffic control. In Canada, development is proceeding on a lighter-than-air aircraft – a modern blimp – with a carrying capacity of sixteen tons. Its ability to move heavy cargo into remote areas will greatly reduce the costs of such carriage.

With better communication and more trade, the cultural impediments to trade have diminished and can be expected to diminish further. English has emerged as the dominant language of international commerce. When Japanese go to Sweden to sell robots and Thais go to Saudi Arabia to purchase oil, the conversations are likely to take place in English. The norms and practices of international commerce are also becoming more standardized, leading to greater efficiency. Furthermore, as standardization proceeds, the 'foreignness' of foreign trade diminishes, reinforcing the push of the technological factors that I have identified.

These developments have important implications for international trade. They suggest that it will continue to grow more rapidly than national production. The implications go further. With cheaper computation, communication, and transport and with lower cultural barriers to international transactions, both manufacturing sites and systems of distribution are likely to experience marked reduction in inventories relative to sales. Once economic agents are able to rely on quick, inexpensive delivery of the items they need, they will hold lower inventories of both work-in-progress and finished products. When they need something, they will simply register their needs electronically and take delivery within forty-eight or seventy-two hours, perhaps from halfway around the globe. Since inventories (including work-in-progress) account for about one-third of capital stocks, this pooling of inventories could result in substantial savings of capital.

Computer-aided manufacturing combined with versatile machine tools makes possible short production runs with the advantages of mass-production costs. A computerized and numerically controlled production process will permit model or design changes at relatively low cost for many items. Unit costs for short production runs of particular models will, therefore, decline. The implications for the scale of plants is unclear. The same machinery and software will be able to be used to make many related products, and the high cost of the basic production process may necessitate large-scale plants. But improved, cheaper microcomputers may reduce the optimum scale of some manufacturing processes. In any case, manufacturing will be more versatile, more adaptable than it is today, a change that will reinforce the fall in transport and communication costs, making possible the delivery of even specialized products on short order.

These developments suggest changes beyond those in international trade. An important one is a decline in the proportion of the North American, Japanese, and European labour forces that is engaged in manufacturing activities. By 2030 – a year modestly outside our period here – all tangible goods (agricultural, mining, and manufacturing) in the United States will be produced with less than 15 per cent of the labour force, down from about 26 per cent now. Thus, more than 85 per cent of the labour force will be engaged in construction and in services (the latter category is too large and diverse to be useful). Other advanced industrialized countries will have somewhat higher proportions of labour producing tangible goods, but as the world becomes more electronic, the downward trend will be just as dramatic.

Agriculture

A second area of advancing technology concerns agriculture. We are about to enter a third agricultural revolution since 1700. The first, which began in eighteenth-century Britain, involved the introduction of crudely scientific selective breeding, swamp draining, and controlled management of cropland. The second started after the Second World War in North America with the systematic application of fertilizer and pesticides, combined with more sophisticated selective breeding of both plants and animals to match them better to their new, controlled environment. The third revolution will involve direct manipulation of the gene pool, through biogenetic engineering and related activities, to produce plants and animals that will do what we most want them to do (for example with regard to the ingestion of food and water or resistence to pests and disease). The full effects of this revolution will not yet be visible in the next fifteen to twenty years, but we will soon feel the early stages of a tremendous increase in agricultural productivity.

These increases will lead to clashes even stronger than those engendered by present agricultural policies. The agricultural policy of the European Economic Community (EEC), which provides high price supports with essentially no limits on production, is already a sore point with Canada, the United States, and other exporters of temperate agricultural products. Farmers are relatively quick to take advantage of any improvements that come along, so the result of new technological possibilities with unchanged policies will be an explosion of agricultural production and a serious collision among competing exporting countries.

New materials

A third technological development, especially important for traditional mineral-producers such as Canada, is likely to be a rapid growth in the use of new materials. Synthetic and composite materials are being developed that have properties – workability, strength, durability, usability at high temperatures – for which we have traditionally used metals. The decline in costs for these new materials will depress the demand for the traditional metals, such as carbon steel, copper, and aluminum. (It is worth noting that one of the largest potential copper mines in the world is under the pavements of New York City. Once alternatives to copper come into widespread use in communications – probably beyond our time horizon here of twenty years – that will be an enormous source of scrap copper). So the commodity composition of world trade will be altered, and some of today's industries will be in secular decline while other grow rapidly.

Countertrade

One feature of the present trading environment that has recently received a lot of attention is countertrade. The term covers a variety of types of transaction, ranging from direct barter of one good for another to complex transactions in which a factory is built on credit to be repaid with the produce of the factory (perhaps supplemented by financial payments). The key point is that a countertrade exchange does not involve only financial payments but also or exclusively some other goods in some way, now or in the future. The GATT secretariat estimates that countertrade transactions now account for 8 per cent of world trade; some more generous definitions put it as high as 30 per cent.

Countertrade arises in four different contexts. The first is trade with communist countries. They have a basic antipathy to the use of money and the price system to allocate resources; barter fits much more comfortably into their system of planning, which is quantitative in nature. The second is defence contracts; they involve visible political decisions to purchase foreign military equipment, which must be seen to be balanced against agreement by the foreign suppliers to purchase products or otherwise ensure employment-generating activity in the buying country.

The third such situation involves the presence of an overvalued currency that the authorities are reluctant to devalue; discounts to stimulate exports can be concealed in countertrade transactions.

The fourth circumstance is trade by parastatals or other large firms in concentrated industries that, for reasons of market stability, do not want to lower their posted prices but wish nonetheless to sell more. Once again, discounts can be concealed through the obfuscation that a complicated countertrade deal permits.

Without going into further detail, I conjecture that the third and fourth of these situations are markedly sensitive to world economic activity. In a time of deficient demand and excess capacity, such as prevailed in the 1982-4 period, countertrade transactions become especially attractive to debt-ridden countries and to firms in oligopolistic industries. For example, the selling agencies of the Organization of Petroleum Exporting Countries maintain posted prices above the market-clearing level and must restrict supply to sustain them; with countertrade, somewhat more oil can be sold without formally breaking the posted price.

I suspect that this behaviour will diminish as the world economy continues to recover from the 1981-2 recession, and the 'trend' toward countertrade will turn out not to be a trend at all. Of course some countertrade will continue, especially in trade with communist countries and in connection with defence goods. But human beings spent millenia developing money as an efficient medium of exchange, and unless there are very special reasons for not doing so, those who engage in countertrade will rediscover that it is better to sell for money.

THE POLICY ENVIRONMENT

International trade in the future will, of course, be influenced by government policies as well as by technological and cyclical economic developments. I distinguish among government policies towards the structure of production ('industrial policy'), government policy towards products allegedly subsidized by other governments, and government policy towards the trading system as a whole.

Industrial policy

Governments in all countries are held responsible for the course of economic events these days – perhaps slightly less so than five years ago, but certainly much more so than five or six decades ago. Although there may be some variations in the degree of responsibility assigned, virtually all societies, nondemocratic as well as democratic, place the fundamental burden on government. The expectation that government will assure the material well-being of citizens often goes well beyond the expectation of maintaining noninflationary growth and high employment. It increasingly includes also the structure of output – or at least so it appears. I confess to some skepticism about the general public interest in the economic well-being of particular sectors of the economy; usually it is labour and firms in the sectors themselves that are most interested in sectoral developments – textiles, steel, and automobiles come to mind. But sectoral interests are couched in arguments that have more general appeal – the desire to foster employment in manufacturing, for instance, or the desire for high-technology activity, somehow defined. (I must note that I consider the usual delineation of high-technology industries to be far too narrow. As I have already indicated, modern agriculture is really a high-tech industry, even though this fact is more manifest in the management of inputs than in the outputs.)

My skepticism notwithstanding, the fact is that most countries now have articulated industrial policies to influence the rate of growth (or decline) of particular sectors of the economy. The traditional instrument for sectoral policies was, of course, the tariff (or similar restrictions) on selected imports. Partly because we now have international trading rules that limit the use of import restrictions and partly because governments have become more adept at using other instruments of policy – credit allocation, tax subsidies, selective R&D expenditures, and even direct management through government ownership of economic activities – industrialized countries can now influence the structure of production with a kit of tools that is far more diverse than the one they had twenty-five or fifty years ago (see Cooper, forthcoming). Often these policies are regional rather than national in scope; think of those used when Canadian provinces or US states try to attract particular firms to locate there. Meanwhile, developing countries continue to rely heavily on commercial policy – tariffs and import quotas – to influence the structure of output.

I see the pervasiveness of such influences as a fact of political life during the next fifteen to twenty years, although the intensity may rise or decline somewhat from present levels.

Subsidies and countervailing duties

So long as governments intervene in economies to influence the composition of output, other governments will complain on behalf of their exporters or import-competing firms. Sectorial subsidies or subsidy-like policies will be seen as trade-distorting and will become a source of grievance.

The main target of opprobrium is domestic imports that seem to be subsidized (unless there is no domestic production, in which case the subsidy is regarded as a boon). But increasingly exporters who must compete in third markets against products that seem to be subsidized are also raising their voices in objection. And in some cases and in some industries, nontariff forms of protection of a home industry have become the targets of attack by would-be exporters to those markets: the recent round of market-opening discussions between the United States and Japan reflect this last type of concern.

This sensitivity is especially great in the United States. Philosophically, if not always in reality, Americans are committed to a relatively low level of government involvement in setting the structure of production. They are also impressed by the merits of a competitive economic system; competition is considered a good thing – at least outside the particular sector with which one happens to be associated. Since private firms are not able to compete with the taxing powers of national governments, Americans tend to consider government subsidies of all kinds, direct and indirect, unfair trading practices. Therefore, they put strong pressure on their government to eliminate or otherwise counter these all-but-universal practices by other governments.

This issue was addressed squarely in the negotiations over the subsidies – countervailing duty code during the Tokyo Round. The United States put forward its 'traffic-light' proposal in 1976, dividing government activities into three categories: those that would be given a clear green light; those that would be clearly prohibited; and those with a yellow-light 'go-carefully' classification – permissible provided they did not create substantial distortions to international trade. For a yellow light action, a complaint would lead to consultation among the relevant parties; if no resolution resulted, the injured party would be able to take countervailing action.

The proposal as originally put forward was not adopted, but the Subsidies Code that was agreed to bears at least some resemblance to it. Export subsidies are clearly prohibited, and an illustrative list of actions that might be considered export subsidies is appended to the agreement. In addition, all signatories undertook to avoid actions that distort trade in a way likely to be injurious to other countries. If trade-distorting practices are not removed or attenuated after consultation, a party that is materially injured can impose countervailing duties equivalent to the calculated subsidy.

The Code is basically a procedural framework based on general principles. The details must be worked out through concrete application. This is being done partly through international discussion in the GATT and use of the Code's dispute-settlement mechanism. In practice it is also being worked out partly by decisions of those semiautonomous entities of the US government that are charged with applying the country's law, including the Code. The decisions are supposed to be politically neutral, and the proceedings are quasi-judicial. Much economic analysis is involved, both in determining what is a countervailable subsidy and in determining whether an industry has been materially injured by subsidized imports. But as happens with Anglo-Saxon common law, the exact meaning of general principles can become clear only as concrete cases are confronted and it is decided whether they fall on one side or the other of an ill-defined line.

An approach to defining countervailable subsidies

On the basis of the cases treated to date, it looks as though the US government is gravitating towards selectivity and motivation as criteria for determining whether a given action by a foreign government constitutes a countervailable subsidy. Is the action intended, directly or indirectly, to stimulate exports? Is it focused on a particular line or lines of activity, rather than being applied to a broad range of activities? For example, general subsidies to R&D expenditures or tax breaks for R&D would not be countervailable under these criteria. But an R&D subsidy to a particular industry would be to the extent that it was reflected in the price of the product and that it caused material injury (Shuman and Verill 1984, 115).

This general approach is sensible. However, it has three problems. First, it will take a long time to build up a comprehensive body of case law so that we know concretely what was agreed to in 1979. In the meantime there is much opportunity to harass trade in the pursuit of protection against import competition. A recent instance was a case brought by American timber interests against the Canadian lumber industry on the grounds that Canadian stumpage fees, which are calculated on different principles from US stumpage fees, provided subsidies (Leyton-Brown 1985). On the merits as I understand them, that looked like an absurd contention; after investigation, the US Commerce Department ruled that the Canadian practice did not represent a countervailable subsidy and dismissed the claim. The plaintiffs appealed the decision, but the US Court of Appeal came to the same conclusion. While the case was under consideration, however, Canadian lumber interests, the US housing industry as a major buyer of lumber, and the Canadian government went through a period of considerable anxiety and expense. For some months this trade was under a cloud of uncertainty.

Because governments do not agree on this sort of detail, we will have a number of years in which firms or industries can harass imports by bringing cases that they believe they will lose in the end. (Of course, they may also hope to find some angle that will win the case.)

The second problem with this approach is that there is no assurance that other governments will follow the interpretation that emerges from US case law. So there will be a lengthy process of international discussion and consultation before we discover what was implicitly agreed to in the Subsidies Code. In other words, this area will be murky and troublesome for a number of years, and we can only hope that the interpreters stay on a reasonable track.

A third problem with this approach is that it focuses on injury caused to a country's import-competing industries and does not deal with injury caused to export industries by subsidized sales to third markets. The importing country may even welcome the subsidy (European butter to the Soviet Union comes to mind) because its terms of trade are improved. This issue has attracted some attention in the United States, and I suspect that we will see it as the basis of more cases brought under the US Trade Act's Section 301, concerned with unfair trade practices. If country A's actions are hurting US exports to country B, the act provides broad authority for retaliating against country A in other areas. The criteria, the procedural safeguards, and the possible remedies are not nearly so circumscribed for cases brought under Section 301 as for cases under the Subsidies Code. If badly handled, the former could be exceedingly troublesome.

Gary Hufbauer and Joanna Erb (1984) suggest a countervailing subsidy to deal with this kind of situation; in the example given, the United States would subsidize the injured industry's exports to B's markets to an extent based on A's. That would work if only three countries were involved, but it might aggravate the problem if there were other suppliers as well. It is an intriguing idea, but it could lead to a very messy structure of countervailing subsidies.

Government approaches to the trading system

The current US administration, with Canadian and Japanese support, is pressing strongly for another major round of multilateral trade negotiations. Not surprisingly, the United States wants to concentrate those negotiations on its issues of special interest – namely, trade in services, high-technology products, and agriculture. It does not exclude, however, across-the-board tariff reductions and other matters. The details of the US approach are not yet formulated. There is a conviction that the world needs another round of trade negotiations to stave off mounting protectionist pressures. There is much less conviction about what the detailed content should be. The strategy is to get agreement on the principle of trade negotiations and then to fill in the details.

This traditional, multilateral approach has two problems, both of which are recognized. The first is what economists call the free-rider problem. Given the existence of most-favoured-nation treatment, many countries have very little incentive to do any negotiation. If negotiations take place between the United States, the EEC, Japan, and Canada, most-favoured-nation agreements convey the benefits to other countries, which thus have little reason to negotiate themselves. As countries such as South Korea, Brazil, and India become economically more important, themselves there is growing sensitivity to the free-rider problem.

Second, to the extent that pressure is put on other countries to avoid the free-rider tendency and negotiate, opposition by some can hold up progress by others. An example is the discussion in GATT about services; most of the developing countries are flatly against any negotiation on liberalizing international trade in services.

It is with these problems in mind that the US government has coined a new term, 'plurilateral negotiations', which are something less than universal or multilateral but more than bilateral. A small group of like-minded countries could work out something among themselves on the basis of negotiations, not most-favoured-nation agreements. Indeed, that is the principle underlying three of the Tokyo Round codes: the Government Procurement Code, the Subsidies Code, and the Standards Code. The signatories to these codes get some privileges and take on some obligations that nonsignatories neither give nor receive. In that sense, this is a movement back to full reciprocity or conditional most-favoured-nation status, rather than the unconditional most-favoured-nation treatment that has governed the tariff reduction of the last forty years.

The United States and bilateral negotiations

Although the preference of the United States is for multilateralism, it is willing to go for plurilateralism, and if necessary, it will entertain bilateralism. This marks a major philosophical change in the US approach to international trade arrangements. Of course, there have been some unilateral arrangements, such as extension of duty-free entry to developing countries under the Caribbean Basin Initiative, and there is the Canada/US Auto Pact. But across-the-board bilateral negotiation is new. Israel took the initiative in 1981; the United States agreed on negotiations in late 1983, and they were concluded in February 1985. Some features of the Israeli/US agreement are noteworthy because they illustrate the kinds of things that the United

States is willing to accept in a bilateral agreement and what it is insisting on. Under the Israel/US free-trade agreement, all trade between the two countries will be free of duty and other import restrictions by 1995 with the exceptions noted below. The agreement acknowledges that if either country has agricultural-support policies in force, there may have to be impediments at the border. Otherwise, the agreement in principle covers all goods.

The agreement provides for a transition period that varies from commodity to commodity; the maximum is ten years. Israel insisted on a balance-of-payments clause, but it has a double stipulation. First, any balance-of-payments derogation must be temporary; it must not last more than 150 days, with the possibility of renewal for a second 150-day period. Second, the derogation must be general in nature. Neither country can select certain products to restrict on balance-of-payments grounds. Either could have a general import surcharge, for example, but not a selective one.

Israel agreed, at US insistence, to sign the GATT Subsidies Code of 1979 and over time to phase out four identified export-subsidy schemes. (There was an extensive debate over what exactly constitutes an export subsidy scheme. Four Israeli programs were finally agreed on as providing export subsidies.) As far as other aspects of industrial policy are concerned, both countries have a free hand subject to the procedures of the Subsidies Code.

As a developing country, Israel is given the right to introduce infant-industry protection but with a 20-per-cent ceiling on the tariff that can be applied and a time limit of 1990 for unilateral action. A joint commission is to be set up; after 1990, it will have to agree to any new infant-industry protection, so, in effect, US approval will be required after that time.

Finally, again at US insistence, there is a protocol on services that declares that both countries intend to permit and encourage international trade in services without undue impediment. This protocol is not legally binding, and the agreement generally treats the trade in services much more lightly than merchandise trade.

The circumstances of the Israel/US trade agreement are in some respects unique, and one hesitates to generalize from them. But the details of the agreement reflect US concerns and thus suggest what its negotiating posture would be in other bilateral trade agreements. The Trade Act of 1984 gives the US administration a general moral endorsement for negotiating bilateral trade agreements but no real authority. The initiative has to come from the other country, and the general framework for the negotiations requires congressional approval. But the Israel/US Agreement may provide a precedent for a network of bilateral agreements if the preferred multilateral approach fails.

PRESENT-DAY ISSUES IN TRADE

The mood on trade matters in the US Congress in the spring of 1985 is the ugliest I have seen it since the widespread support for the Burke-Hartke bill in 1970 and 1971. Most of the ire is focused on Japan, in my judgement, mistakenly. Conventional American wisdom on this subject, as reflected especially in the business community, the Congress, and the press, has a fundamental flaw: the assumption that 'opening the Japanese market' would reduce the huge US trade deficit or the large Japanese trade surplus. Large imbalances in trade are not caused by protection, but by macroeconomic factors, in particular by the relationships among private savings, domestic investment, and government budget surpluses or deficits. To put the point in excessively strong but not fundamentally inaccurate terms, if Japan reduced all its barriers to trade, that would not lead to a smaller US trade deficit or even necessarily to a smaller Japanese surplus. The overall US deficit is the result of an imbalance between US investment and US savings (the latter includes the dissaving implicit in the federal budget deficit). Japan's barriers to imports have little to do with it. Of course, Japan's quota on citrus fruits limits US exports of that commodity; but an increase in US citrus exports to Japan would not necessarily or even probably reduce either the overall US deficit or the Japanese surplus; those are determined by macroeconomic factors and compensating adjustments (for example, the shift in the exchange rate that would take place in response to increased citrus sales). But that fact has not prevented frustration, arising from the size of the deficit and the impact it has on US manufacturing, from spilling over into strong resentment about what are seen to be restrictive trade policies and practices on the part of Japan. Unless this resentment is managed skilfully by the US and the Japanese administrations, it could result in a burst of protectionist legislation.

I have already discussed both the sensitivity in the United States to actual and alleged subsidies to exports by other governments and the quasi-judicial procedures for dealing with them. These procedures are under close and critical scrutiny by business firms, labour unions, and the Congress to be sure that they work against unfair trade practices and that cases are not dismissed on foreign-policy grounds.

Another pertinent issue is selective safeguards. An impasse now exists in the GATT on that subject. On one side of this debate is the EEC, which is a strong advocate of selective safeguards and has said, in effect, that if it does not get them in the GATT, it will get them outside it, a position that is having a coercive effect on the GATT itself. On the other side are the developing countries and Japan. They strongly resist the formal endorsement of selective safeguards, which they fear will be directed at them. The impasse continues. Various proposals have been made for resolution focusing on agreement to the principle of selective safeguards but putting them under strong international surveillance. It remains to be seen whether that kind of agreement can be worked out.

Finally, I want to mention the problem of the developing countries as a group. We now have two sets of rules within the GATT: one applying to industrialized countries and one applying to developing countries. The second set (part 4 of the GATT) was put in at the insistence of the developing countries, with the industrialized countries acquiescing on basically political grounds. In my view, it is corrosive for any organization to have some members that assert rights but do not accept obligations and other members that are assumed to have obligations as well as rights. Such conditions can exist temporarily, for a transition period, but no organization can function on an enduring basis under such an arrangement. It is no favour either to the GATT or, in the long run, to the developing countries themselves to exempt them from the GATT obligations. As these countries develop, their officials will want to reduce their high import restrictions. But in the absence of tight, autocratic government, they will find it very difficult to do that unilaterally. Economic interests will block trade liberalization. The argument that the international community insists upon it is usually a necessary political lever for achieving trade liberalization.

CONCLUSION

National and indeed local populations everywhere are at heart mercantilistic. There is a fundamental feeling that although it is, of course, necessary to buy since we have to eat, acquire needed materials, and so forth, it is better to sell than to buy. That widespread instinct is a fact of political life, creating pressure on national policy in all countries. At the same time it is difficult to avoid the conclusion that the historically unprecedented growth of the world economy in the last forty years – thirty-five years if you leave aside the immediate recovery from the Second World War – was not intimately related to the great liberalization of trade that took place during that period. The latter was partly a liberalization of trade policy, the removal of tariffs and other barriers to trade since 1947. But it also reflected sharp declines in the natural and social barriers to trade, in the costs of transportation and communication, and in language and other cultural barriers. As a result, international trade is freer today than it was even in the heyday of the free-trade movement back in the 1860s or 1970s, in spite of the backsliding that takes place from time to time these days. As I say, it is hard to dissociate the enormous economic progress from that liberalization in trade. Further trade liberalization might not result in commensurate gains, but it would surely result in some additional gains. Perhaps much more important, further trade liberalization would help to avoid a reversion to the natural inclinations towards mercantilism. Unless we keep moving forward, that instinct is likely to prevail and move us back towards a much more restricted trading regime, which surely would work to the disadvantage of all countries,

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Discussion

R.J. WONNACOTT (University of Western Ontario): Would you elaborate on your comment that liberalized trade with Japan would not affect the US trade deficit or the Japanese surplus. Would it not affect the US trade deficit with Japan?

RICHARD COOPER (Harvard University): A lot of public discussion has focused on the US bilateral deficit with Japan, which in 1984 was some $36 billion, about one-third of the total US trade deficit. That is a number I have no interest in. We have worked for more than thirty-five years to build a world of multilateral trade. As my Australian friends like to remind me, the United States has a surplus with Australia, Australia has a surplus with Japan, and Japan has a surplus with the United States. That's the kind of pattern you would expect in a world of multilateral trade.

To answer Professor Wonnacott's question, my assertion concerned the overall trade positions of Japan and of the United States. Liberalization in Japan might influence the bilateral US/Japan imbalance, but in my view that kind of reshuffling is uninteresting.

BERNARD WOLF (York University): Since you're doing some crystal-ball gazing, Dr Cooper, what kind of safeguards do you think the United States would accept vis-à-vis Canadian manufacturing, given that Canadian industry has a lot more adjusting to do than US industry?

RICHARD COOPER: In principle, none. No special deals are to be had. In practice, I think a lengthy transition period would be acceptable. The way the US/Israeli agreement is drawn is interesting. Commodities are divided into four categories: One category is to be liberalized as soon as the agreement is ratified, which is expected to be this year. Goods in the second category will have a three-year adjustment period; goods in the third category a five-year adjustment. The most difficult cases will have a ten-year adjustment period, with the phasing in the second five years not yet negotiated. So conceivably, the complete adjustment in tariffs might not take place until 1995.

Incidentally, that's the same way the European Community handled the entrance of Greece and now Spain and Portugal. The phasing of the adjustment period was negotiated, but using a clear principle: at the end of the day, no special deal.

QUESTION: A basic question. I'm still not clear what the United States means by 'high- technology', particularly with regard to multilateral trade negotiations.

RICHARD COOPER: I agree, it's not at all clear. They seem to have in mind particular products in which there's special difficulty in selling abroad – products used in electrical generation, telecommunications, space industries, and so on. One of the problems here, as the United States sees it, is in organization. In most other countries, public utilities – the electrical authority, the telegraph, telecommunications – are state owned, and imports from abroad are sensitive. By longstanding tradition, the major countries – Britain, France, West Germany, Japan – do not have imported equipment for these industries, whereas the United States does. For example, the United States imports about 20 per cent of its hydroelectric equipment, but you don't find France or Japan importing hydroelectric or telecommunications equipment.

So those are the irritants the US government is going after, trying to open those areas of trade to international competition. But apart from these particular examples, there's no clear definition of the scope of 'high-tech trade'.

SIMON REISMAN (Reisman and Grandy Limited): Dr Cooper, I'd like to go back to the Japanese problem for a moment. I have no quarrel with your emphasis on getting away from looking at trade relationships in terms of bilateral balances between countries. But you left the impression that the Japanese trade policy is a reasonably open one and that if there are difficulties exporting to Japan, they relate to the problems and policies of other countries, not to those of Japan. But isn't there a whole range of things in which Japan is trying to be protectionist. Agricultural products come to mind as an example.

In addition, I think people who've tried to penetrate that system have found that a lot of Japanese restriction is done by mirrors. The Japanese claim to be in favour of multilateralism – in fact, they are now joining the United States and Canada to push for another round of talks – but they have devices whereby they do not trade on the same basis as other people trade.

RICHARD COOPER: Thank you, because I don't want to leave a wrong impression. In my judgement, we have to distinguish among three quite different things. One is the trade policy of the Japanese government in the English sense of 'government' – the people in charge, the cabinet. Second, Japanese trading practice. And third, the trade outcome. What I said earlier addressed the third of those, the trade outcome. My view is that the *overall* trade outcome – not the composition of trade – is a result of macroeconomic policies in Japan (and elsewhere, but mostly in Japan).

With respect to trade policies, I suggest that the Japanese government is no more restrictionist than any other major government today. You put your finger on the most sensitive area: agriculture, especially rice. Japan maintains a rice price about three times the world price: much higher than European support prices, but without the export subsidies. In addition, Japan has quota restrictions on about a dozen and a half products – mostly food products – claiming sociological reasons for maintaining tight trade restrictions. Leaving rice aside, if those restrictions were swept away, the rise in imports would not be great; it has been estimated of the order of $0.5 billion. Thus, I think Japan is no more guilty of restrictiveness in trade policy than the United States and far less guilty than the European countries.

It's in the intermediate area, Japanese trade practices, that the real problem lies. There's no question that what you say is true. Most people who have tried to sell in Japan have met endless frustrations and harassment. My personal experience is in the area of civil aviation; I have encountered landing restrictions, problems getting fuel to the planes, ground-handling problems, one thing after another. They find some way to try to limit competition.

I do not believe that this is a matter of government policy as I first defined it. In fact, I know that these practices are a matter of considerable frustration to the ministers. The problem arises from deeply rooted cultural attitudes that infuse middle managers in private firms and middle-level bureaucrats in the government ministries. They feel that their country is a desperately vulnerable country – it has to import all its raw materials and much of its food – and that if they can possibly produce any goods or services in Japan, they should. Therefore, they throw up administrative barriers of various kinds. These attitudes are deeply ingrained, and they are not going to disappear short of a generational change.

However, even if you could sweep all these protectionist practices away, it would not change the overall Japanese trade position because that is determined by several fundamentally different variables. One is the extraordinary Japanese savings rate. Another is the Japanese investment rate; it used to be as extraordinary as the savings rate, but a decade ago it dropped sharply (although it is still high by international standards). The impact of that drop on trade was concealed by the introduction of a very generous social-security system in the early 1970s and by big budget deficits, which the Japanese have been attempting, with some success, to reduce since 1980. The result is a huge discrepancy between national savings and domestic investment. One way of putting it is that the Japanese public wants to save more than Japanese firms want to borrow. For a number of years, the gap was filled with government paper. That's now changing as the budget deficit is reduced. The Japanese are having to invest abroad, and that's what they are doing to the tune of nearly 3 per cent of GNP, which is an extraordinarily high figure. A weak yen and very competitive Japanese products are the results – which have nothing to do with protective policies or practices.

DON DALY (York University): The source of Japanese competition with the United States is important to understanding the United States in relation to the rest of the world. An alternative interpretation comes from the work of Bruce Scott. He argues that the key contribution to the success of Japan and of the newly industrialized countries is the high priority they put on economic growth and the low priority they put on income redistribution. Some of my work suggests that given, say, 1983 exchange rates and productivity levels about half way between those in Canada and the United States, unit labour costs in Japan are something like 40 per cent less than those in the United States. That's a very significant difference. I agree completely with your tone – that reducing Japanese tariffs really wouldn't change the trade picture – but I'm less sure about your insistence on putting all emphasis on macro areas.

RICHARD COOPER: In my judgement, the things Bruce Scott points to, however interesting and important they may be to life in general, cannot by themselves explain the large Japanese trade surplus. Essentially, he neglects the exchange rate, and those wage comparisons that you make are determined by the exchange rate. That's the first point.

Second, Bruce Scott and others who have discussed this question are simply out of date with respect to the Japanese welfare system. They would have been correct in the 1960s, but today, although Japan is not where the United States or Canada is, in some respects in others it has leapt over us. I note that one argument you don't hear with respect to Japan's success is that it's lax on pollution requirements; that's because it has the stiffest in the world. I have no doubt that if they were somewhat weaker, critics of Japan would have added that to their roster of items.

It depends on what you want to explain. If you want to explain the strong Japanese current account or trade position, it is a mistake to look at the strength or weakness of its welfare system. Let me explain by giving a counterexample: over the last decade, the Netherlands has had a very strong current-account position, yet it also has as advanced a welfare state as any country in the world. You just can't go from welfare stateism to these kinds of macroeconomic phenomena.

Now, Bruce Scott may be putting his finger on a different kind of phenomenon: work attitudes. They can certainly affect the growth rate of income over time, though they fall in an area in which economists should tread lightly since it is really the domain of social psychologists. But to the extent that the work ethic is weakening in West Germany or the United States or Canada but not in Japan, that change will be reflected in higher Japanese growth rates but not necessarily in a trade surplus. Overall trade performance is a macroeconomic phenomenon.

SIMON REISMAN: You talk about Japan's having adopted advanced social policies. But my impression is that it hasn't in at least three areas, all of which relate to the rate of savings. First, food is terribly expensive there. If the Japanese ate a little more, they'd save a little less. Second, housing. They still crowd six or eight people into a very small area that doubles for sleeping and eating. I am sure that if people could improve their housing standards, they would want to and they would save less to do so. Third, however well advanced the

Japanese welfare system may have become, there's an almost deliberate policy of keeping women down. They pay them less than a third of what they pay men for the same work. Now women are good consumers. Paying them for the work they do and allowing them to spend their earnings might bring down the Japanese savings rate.

RICHARD COOPER: I will pass on your first comment, since I'm not sure that eating more means saving less. But I agree entirely on your point about housing. Japanese financial institutions for housing can only be described as primitive, and I have no doubt that if the country had a more developed mortgage market, its household savings rate, net of spending on housing, would decline. Housing in Japan is also related to agricultural policy through land use. Farmers in Japan tie up a lot of land that, without the high price supports for rice, would have been converted to urban land.

As for your third point, I am not sure you're right. Women may be great consumers, but in many societies it is the women in the family who are the savers, not the spenders. The other thing that may surprise you as much as it did me is that among the industrial societies, Japan does not have anything close to the lowest rate of female participation in the work force. A number of European countries – Britain, in particular – have markedly lower rates. So Japanese women do work, and my guess is that they also save.

QUESTION: Does Japan's policy on defence spending affect its trade outcome?

RICHARD COOPER: Well, it does as far as the budget is concerned. The relative size of their spending is debatable – the way it's calculated in Japan, where the issue is politically sensitive, puts it at just less than 1 per cent of GNP. If you put it on a NATO-comparable basis, it's close to 2 per cent. But it's lower than in most of the other advanced industrial democracies.

My own view is there is nothing special macroeconomically about defence spending – it's just one kind of government spending. What is really noteworthy is that Japan stands lowest among the advanced industrial countries in its ratio of all government spending to GNP. That fact raises the question of what public goods the Japanese are going short on. Defence is one, but only one; other areas in which there could be more public spending are housing and highways and things like that. But I believe it's up to each society to decide the balance it wants to strike between public and private spending – that's what democracy is all about, after all. As long as a country gets the macroeconomics right, the rest of the world shouldn't care much exactly what public/private balance it strikes.

MURRAY SMITH: I agree completely with your observations about the importance of the macroeconomic variables in Japan. As economists, all we can really find interesting about the current-account imbalance of the United States and Japan is that if it runs for seven or eight years, the asset positions of those countries will shift enormously, which will have long-term consequences for trade flows.

What concerns me is the political response in the intervening period. The reality of the factors determining those trade flows is not as important as the perceptions associated with them. Look at the attitude towards Japan reflected in the actions of the US Senate over the last few weeks. How is the United States going to emerge from this protectionist period and take a leadership role in another round of multilateral negotiations under the GATT? Or will bilateral negotiations become the only game in town?

RICHARD COOPER: I think it's too early to tell. The Congress is not initiating; rather, it's reflecting the mood of the public, which is currently hot under the collar about trade issues in general and Japan in particular. The administration, I think, is basically not sympathetic to any of these congressional moves. Although this administration, like others, does not speak with one voice, its basic strategy – and that of the Japanese government – is to manage the political heat until we get through to a calmer period. Getting there is going to involve Japan's making some concessions, which I suspect will have a greater cosmetic than real value. Then the US administration can trumpet these concessions as a way of warding off the most offensive pieces of legislation. That's a process both governments have a lot of experience at. It's a risky game, and there's always the possibility of things slipping out of control, but I think it's probably the best tactic the administration can pursue at the moment. In the meantime, it can push for multilateral negotiations with Japanese support. By itself, that action will help quiet the most active protectionist pressures, because the administration can say, 'Well we're in active international negotiations; we don't want to jeopardize them'. That's another strategy that has worked in the past.

Where I fault the American administration is in not being as unambiguous in its opposition to some of the most offensive bills as it has been in other areas. You hear the president say time and again to the Congress, 'You pass that and I'm going to veto it'. He could and should come out as firmly against trade restrictions aimed at Japan.

The problem goes back to macroeconomics and politics. The US trade deficit is not going to go away until there is some kind of resolution on the US budget. The president is not willing to compromise his principles, and as long as he doesn't, the Democratic-controlled House of Representatives is not going to compromise its principles. So while everyone voices the necessity of reducing the budget deficit, the political impasse continues. In our system, the Congress has great difficulty taking a successful initiative on a complicated issue. So it's really the president who bears the responsibility. Nothing's going to happen until he shows more flexibility than he has shown so far.

R.J. WONNACOTT: We used to think that the problem with budget deficits was damage to the domestic capital stock. But it seems to me the larger problem is damage to the international trade system. Most of the crowding-out has been on the international-trade side. And that generates pressures for protectionism in the United States, which has been the home of liberalized trade, if it has a home anywhere.

RICHARD COOPER: Basically, I agree. However, it's important here to give dates in statements. My assessment differs, at least somewhat, depending on what year you're talking about.

Let's look at US domestic investment. The path the country has followed is very similar to the one it followed in the past when budget deficits were much smaller. In the recent slump, gross investment dropped to 13.5 or 14 per cent GNP; in 1984, a boom year, it went up to 17.5 per cent. If we didn't know anything about the surrounding environment, those figures would not suggest that the last three or four years have been exceptional compared with previous years. So in that sense, there hasn't been any reduction in the US capital stock.

But if you peek beneath the rug, so to speak, you find this extraordinary structural budget deficit, which we haven't had in the past. How has it been financed? It's been financed from abroad. That's where dates become important. From a global point of view, there was really excess savings in 1982 and 1983 and even to some extent in 1984. In fact most of the growth of most countries – Japan was a partial exception in 1984 – was generated by exports. There was very little internal demand. In other words, the US trade deficit has been the mechanism for transmitting the US recovery to the rest of the world. Given the openness of today's economies, crowding-out has to be looked at from a global point of view, and I suggest there hasn't been any yet. Rather, there was a big slump with a lot of excess capacity, and the export demand was welcomed.

Now, as we move into and beyond 1985, I think one has to worry about global crowding-out and what large budget deficits do world capital stock. Remember, I'm not talking just about the United States. It happens to be unusual in US experience to have a deficit of 5 per cent of GNP, but many other industrial countries, including Japan and West Germany, had deficits higher than 5 per cent of GNP in the late 1970s and early 1980s.

The real question, as you said, is whether the liberal trading system can survive protectionist pressures that arise in an economy that's buoyant but is suffering sectoral impacts that are severe because of the strong dollar and the large net foreign investment in the United States, whose counterpart is the large US trade deficit.

A.E. RICKARDS (Canadian Pulp and Paper Association): A few years ago one of our member companies sold for the first time paper stock for directories. I asked the man who actually sold the stock, 'How did you do it?' He said, 'Well, it wasn't the bosses I had to convince. I had to go down to the printing floor with my interpreter, take a roll of my paper, and show that it actually ran on their machines. I had to stay with them for days and days, and eventually these printers, who were culturally geared to the Japanese product, said, "We'll accept your paper".' That's apparently the way to do it.

Also, at least in the paper industry – I suspect it's true elsewhere – the old men don't retire. They're put out to pasture in places like the purchasing or distributing company of the firm they've worked for. So a whole cultural way of buying paper has built up. It's not something you can change by a treaty.

Incidentally, the Japanese regard our industry a very protective and difficult one to penetrate. They have the same kind of complaints about us that we have about them.

RICHARD COOPER: That's an interesting story illustrating a key feature of Japan business: a strong sense of loyalty to a firm's customers, employees, and suppliers. Often, I am told, when a foreign firm says, 'Look, we have produced a better or a cheaper widget', a potential Japanese buyer finds out as much as possible about it, then goes to his traditional supplier and, in effect, gives him the right of first refusal. 'I've dealt with you for fifty years. I've been offered a product I really can't resist, and I can't put myself out of business. But if you can match this product, I'll help you. I'll even give you a year to come up to the standard that the foreigner is offering me'. As you say, that is a marketing problem that is exceptionally tough to crack.

T.R. ROBINSON (Consumer and Corporate Affairs, Hull, Quebec): Dr Cooper, do you have any thoughts about whether the increasing importance of trade in services, especially services linked to high technology, has the potential for significantly changing the nature of the GATT and of other international agreements and negotiations? Will it really be a new ball game?

RICHARD COOPER: I always cringe a little bit at references to services because it is such a catch-all term that I think it has ceased to be a useful category. As in the case of the high tech we talked about earlier, the US government and a lot of governments and people are not entirely clear what they mean by 'service'. Clarification usually comes from making distinctions, not by lumping dissimilar things together. Once we decompose 'services', we discover we do have some trade arrangements on them after all. They're not in the GATT, but we have international agreements on some highly specialized services: – civil aviation, maritime traffic, telecommunications – and various kinds of technical agreements. So the question is whether there should be economic agreements on services.

What the United States would like to do is get an understanding, as in the US/Israeli free-trade agreement, that services will not be put intellectually into a separate category from goods, that the objective ought to be liberal trade, if not free trade, in services as in goods. There may be reasons a country wants to have exceptions here or there, but they ought to be seen as exceptions rather than as the general rule. For example, the United States makes an exception of shipping services, about which it has been as restrictive as other countries. But it would like to see more competition in civil aviation and in the whole range of data services made possible by the telecommunications revolution.

What's opening up the whole issue of trade in services is the increasing importance of that subcategory of services associated with computers – software, design, data manipulation, and so on. We risk a late-twentieth-century version of physiocratic fallacy. The physiocrats, you remember, thought that the only thing real in national economies was agricultural production; everything else was secondary. Well, today we've become so fantastically productive at agriculture that we tend to take it for granted, but we attach primary importance to manufacturing. Somehow, it's only real if it's tangible. In fact, these high-tech machines are just pieces of junk without software.

Another subcategory of services is the whole financial area – banking, life and liability insurance, and so forth. There's no international regime in that area. In both our countries, these services tend to be treated on a national or a provincial or state basis. The banks and, increasingly, the insurance companies have found various ways to arbitrage around these jurisdictional provisions, and in the end, I suspect pension activities will, too. There's no reason pension funds shouldn't be diversified worldwide in the interests of recipients.

So these things are opening up. But they have to be taken discretely. You can't lump software with banking with shipping. Each poses separate kinds of problems.

Rapporteur's comments: which way for Canada at the crossroads?

Richard G. Lipsey

Canadian Trade at a Crossroads has been a fascinating conference with an unusually diverse set of papers. In the face of this diversity, I must be selective. So I have picked out a few themes that seem interesting and illustrated them by referring to various papers.

THE IMPORTANCE OF THE BASE CASE

The first such theme is the importance of the base case – the situation that is expected to prevail if present policies are kept more or less in place. If we are to estimate the possible effects of and judge the case for new Canadian policies, we must be able to compare their outcomes with those of this base case.

Notice that the base case is *not* the present economic situation. Major economic forces are clearly at work worldwide, so even if present policies are unchanged, the state of the Canadian economy will change. In fact, Dick Cooper gave the conference a few fascinating insights into the broad scope and rapid pace of changes that are taking place in the world's economies. The implication is that economies must stay flexible enough to adjust to rapid change. Any attempt to resist change by freezing the existing industrial structure – as Canadian policy makers are continually tempted to do – is doomed to defeat, just as it always has been in the past. But defeat will come sooner than in the past because of the accelerating pace of technological change.

Dr Lipsey is senior research advisor at the C.D. Howe Institute and Sir Edward Peacock Professor of Economics, Queen's University.

Thus, the base case is the situation that will arise from maintaining the status quo of present policies and accepting the consequent changes in the state of the economy. The majority opinion of the participants in the conference was that this base case will be unsatisfactory for the Canadian economy. I will run through the views of those who expressed themselves on this important matter in the order that they are presented in this volume.

Sylvia Ostry spoke of the great risks posed by present policies and attitudes throughout the world.

> What is at risk is the carefully constructed postwar edifice of multilateral discipline designed to ensure the stability and predictability without which market economies cannot function. The slow relentless erosion of that system is dangerous precisely because the process is not clearly visible, thus creating a false air of security and an illusion of stability.

The view that the status quo is not an acceptable option seemed to be held even by those who were not attracted to the trade-liberalizing solution. Although Cliff Pilkey did not directly address the question, his list of desirable policy changes suggested that he agreed with the other speakers that the status quo is unsatisfactory.

Alton Cartwright, speaking from a business point of view, told us that the status quo is 'a formula for disaster'.

James McNiven agreed that the status quo, which he called 'drift', is unacceptable. He worried that it will lead to the United States' getting an ever-rising share of our trade until that country is able to exercise monopsony power over us. He proposed, as a solution, that we make a good trade deal with the United States now, before that power is exercised and that the deal take the form of a free-trade agreement.

It is worth noting, however, that American monopsony power already exists and is being exercised through the instrument of tariffs. The perfect exercise of such power takes the form of what economists call the 'optimum tariff'. Optimum tariff rates are probably not now being levied, but existing tariffs do allow for substantial exercise of American monopsony power.

Let us see how this power works. Because of the size differential between the two countries, the international prices of many traded goods are set in markets in which US actions can influence prices but Canadian actions cannot. To sell goods in the United States, Canadian exporters must accept a payment equal to the US price minus the tariff. Thus Canadian capital and labour in export industries pay the American tariff. The Canadian tariff, on the other hand, raises the prices of US imports in the Canadian market (if American firms cannot get in Canada the after-tax prices available in the US domestic market, they will not export here). Thus, Canadian consumers pay the Canadian tariff. This asymmetrical position – Canadians pay both the Canadian and the US tariff – represents the Americans' exploitation of their monopsony power. Thus, one reason to get a trade deal with the United States now is *not* to avoid the future exploitation of the Americans' monopsony power – the tariff allows them to exercise it now. But a free-trade deal would eliminate this exercise of this power, which results in Canadians' bearing most of the costs of both countries' tariffs.

To return to the rundown of conference speakers, Carl Beigie and James Stewart told us that many Ontario policy makers do not share the gloomy view of the status quo:

> Support is widespread in Ontario for the view that it is inappropriately extreme to claim that Canada is at a crossroads in trade policy. An alternative formulation that would find broad agreement in the province is that world trade is on a bumpy stretch in an otherwise well-constructed road that Canada should not depart from significantly.

Beigie and Stewart themselves, however, shared the view that the base case is unsatisfactory. They believe that if Ontario sticks with the status quo of present policies,

> The miniature replica subsidiaries that have been so important in the development of Ontario's tariff-sheltered manufacturing sector will either be shut down or relegated to nonproduction activities (such as services). Parent companies will relocate production facilities in the United States or, more likely, move their Canadian- and their US-based branch plants to newly industrialized countries (NICs), which offer substantial labour cost advantages. In short, much of Ontario industry is already highly vulnerable to foreign competition, irrespective of Canada's tariffs.

Beigie and Stewart, whose mandate for the conference was the Ontario perspective, argued that these forces make the province's cautious, status-quo-accepting approach fraught with risks:

> What concerns us is . . . [Ontario's] failure to appreciate the gravity of the challenge of international competition (largely because the Ontario economy has been carried along by the recent US boom), and a tendency to underestimate the magnitude of the protectionist sentiment in the US Congress.

Brian Scarfe, speaking from a Western point of view, concurred in the majority view that the status quo of current policies is unacceptable. He also argued the traditional Western case for the consumption advantages of freer trade with the United States.

Don Daly added his agreement:

> The status quo (including wages, exchange rates, and productivity levels relative to other countries') is no longer able to provide to the corporate manufacturing sector increased real wages, low unemployment, and adequate rates of return countries' on further investment in modernized, more efficient facilities that use new technology more adequately.

The main dissenter seemed to be Mel Clark. Although he did not address all the reasons usually given for being unsatisfied with the status quo, he did deal with one: the worry that Canadian exports to the United States will suffer from the growing tide of American non-tariff barriers. Clark denied that this is – or is likely to be – the case. (This raises an interesting issue that ought to be resolved since every other conference participant who considered this issue disagreed with Clark.)

John Crispo argued that for Canada to exist as a wealthy industrial country, it must have 'secure access to America's large and wealthy market', an access that he sees slipping away under the status quo.

Even Abe Rotstein, whose other views placed him in a minority at this conference, agreed that the status quo is unacceptable. In a burst of poetic hyperbole he told us, at the risk of 'only slight exaggeration', that 'more trade barriers have been erected in the last four years than were dismantled in the previous forty'. I will discuss Rotstein's remedies later; what is important here is that he held that the status quo of present policies is unsatisfactory.

Murray Smith and Debra Steger dealt with the base case with respect to the General Agreement on Tariffs and Trade. If the status quo of current policies continues, the GATT will provide our only channel for further trade liberalization. But, as Smith and Steger observed, the GATT is beset with problems. The formation of European Free Trade Association and the European Economic Community and their preferential arrangements with many developing countries have undermined the GATT system. Many developing countries have acceded to the GATT but resist its existing obligations and their extension. The congenital defects of the GATT have become increasingly troublesome over time, and its amendment has so far proven impossible. For these and other reasons, Smith and Steger are pessimistic about Canada's chances to get further major trade liberalization by working through GATT institutions.

Finally, Simon Reisman saw real danger in sticking with the status quo and working solely through the GATT for futher trade liberalization.

> A case can be made (indeed, has been made) that the trading framework of the postTokyo Round of GATT agreements gives Canada the worst of both worlds. On the one hand, our tariffs are too low to protect the home market. On the other hand, our access to the US and world markets remains precarious.

As a result, the outlook for Canada under the status quo is unfavourable:

> The emergence of trade blocs, the relentless sweep of new technology, the limited negotiating scope left for Canada at present [tariff] levels, the more frequent resort to and threat of escape-clause actions, and the danger of a new wave of protectionism engendered by exchange-rate instability suggest that a policy based on reliance on GATT alone will become increasingly difficult to sustain.

The degree of agreement was indeed impressive. Whatever policy makers in the various provinces may think, the participants in this conference were almost unanimous in agreeing that the base case will be profoundly unsatisfactory for Canada. Some major shifts of policy are required to avoid the results of sticking with current policies.

THE CALL FOR BILATERAL TRADE LIBERALIZATION

A second main theme that I identified from the conference was the majority agreement that the package of policies needed to move us away from the status quo includes major liberalization of Canadian trade and that achieving this situation will probably require reaching a bilateral, comprehensive, trade-liberalizing agreement with the United States.

Not every paper writer considered this question, but of those who did, a majority felt a Canada/US bilateral initiative would be a key part of any new policy package. Cartwright, McNiven, Beigie and Stewart, Scarfe, Crispo, and Reisman specifically favoured a bilateral agreement with the United States. So did Richard Harris, Lorne Seitz, Ron Wonnacott, Arthur Smith, and Rodrigue Tremblay (the last was the most outspoken of those who added the condition that any agreement must contain provisions sufficient to ease the transition period. Ostry and Daly favoured trade liberalization without making a specific pronouncement on a bilateral initiative with the United States (their papers did not call for taking a stand on that issue). No one felt that a bilateral arrangement would or should preclude pushing for further multilateral liberalization through the GATT.

'The role of government in export promotion: trade liberalization and competitive markets, versus government assistance to exporters versus broad productivity programs' was the topic presented to the speakers at one conference session. Seitz and Arthur Smith, who were the two to address the question directly, said no choice is needed. Seitz argued, for example,

> Without trade liberalization, we run the risk of . . . losing the markets we currently have. . . . Without broad productivity programs, we run the risk of slipping further behind in the race for that continually moving target – international competitiveness. Without some measure of government assistance to exporters, we are asking Canadian exporters to enter the game against competitors who have one or two aces already in their hands.

These speakers encouraged Canada to pursue liberalization on both the multilateral (GATT) and the bilateral (US) fronts. They were skeptical of government policies to pick and back winners but in favour of generalized productivity-increasing programs. They also generally agreed on some government assistance to exporters. For example, the provision of some market information is no doubt subject to scale economies, so the government can provide it more cheaply than can individual exporters.

A major disagreement was on the subject of export subsidies (in such forms as cheap export-credit insurance or financing at below-market interest rates). André Raynauld pointed out that such schemes distort trade in the same way as do other subsidies and tariffs. As a result, he was generally opposed to them. The men from the trenches felt, however, that such schemes are necessary if we are to compete with countries that employ them.

The nay sayers

Four speakers were highly skeptical of or downright opposed to a bilateral trade initiative with the United States. Bruce Wilkinson was skeptical and stressed what he saw as the many risks, although he did not seem willing to condemn such an approach outright.

Abe Rotstein was opposed. Although he agreed that 'the global trading system stands on the edge of disarray', he felt we should turn our attention to alleviating a series of domestic economic weaknesses while dealing with the rising tide of US nontariff protectionism on a 'case-by-case basis', using, where necessary, the threat of retaliation. I fear that the US Congress is unwilling to deal with nontariff barriers piecemeal, so our only chance of dealing effectively with them is within the framework of a comprehensive agreement. Also, it is a common observation that the size difference between the two countries means that Canada has vastly more to lose than does the United States from the type of retaliatory war that Rotstein advocates.

Mel Clark was clearly opposed to a bilateral arrangement with the United States. His arguments fell into two main categories. First, as already mentioned, he believes that American nontariff barriers pose a much less serious threat than others see in them. Second, he argued, Canada would not be able to contain, let alone reduce significantly, these barriers by means of a bilateral agreement. I lack the space to deal with Clark's arguments here, but Murray Smith and I have recently offered a list of practical suggestions for reducing the impact of American nontariff barriers, in the context of a Canada/US agreement, in ways that are consistent with the American insistence on a 'level playing field' (Lipsey and Smith 1985, 144-60). At the conference, Smith and Steger mentioned one of these: that countervailing tariffs should be levied on the net difference between the US and the Canadian subsidy in any particular industry.[1]

The fourth dissenter, Cliff Pilkey, went furthest in his objections to trade liberalization with the United States – or any other country, for that matter. He would prefer an 'inward-looking' policy alternative not unlike that which Abe Rotstein advocated in his 1984 book *Building from Within* (although it was not in his paper to this conference). John Crispo told the conference this type of policy package would be 'suicidal in its inevitable impact upon the nation's future standard of living'.[2]

INVESTMENT

A third major theme at the conference was the influence on investment of changes in trade policy. Here the authors placed their emphasis almost exclusively on one of the great issues of the trade-liberalization debate: the effects on investment in Canada of a bilateral Canada/US agreement.

Pessimistic views

The speakers opposed to a bilateral initiative tended to be pessimistic. Cliff Pilkey predicted a major decline in American investment in Canada that would be 'dramatic if not disastrous' since, in his view, free trade would lead to 'the almost immediate elimination of a range of labour-intensive industries in Canada – textiles, clothing, food and beverage, furniture and machinery are examples'. The reasons he gave were 'the branch-plant nature of most Canadian manufacturing' and the existence of low-wage, alternative sites for production in the American states that have right-to-work laws.

Wilkinson saw as the 'highly likely' result an expansion of American ownership and control of Canadian industry, at least in the short run because he believes that American firms 'would be better equipped to take advantage of reduced trade restrictions than would average Canadian firms'. He also doubted foreign ownership and control would diminish in the long run. His argument was that although the trade-induced prosperity would cause new savings, a large proportion would be foreign-owned. The expanded Canadian savings would mean 'only the purchase of more minority-equity interests in foreign-controlled firms or more Canadian lending to foreign firms, not any diminution in foreign decision-making authority'.

Rotstein expected 'an important segment of our US subsidiaries either to close up shop entirely or to scale down their operations to sales and distribution networks. Warehousing will replace manufacturing'. He foresaw many industries 'going under' with further unemployment that would 'pile on top of the existing base rate of 10 per cent'. Further, he saw American-Japanese industrial rivalry in a novel way – as a struggle akin to a shooting war in which the winner will take all and the loser will suffer 'industrial attrition' – and wondered about Canada's fate if we tie ourselves to the US market and the Americans lose the struggle.

Neither Pilkey nor Wilkinson compared their scenarios with a base case. Rotstein did, however, and concluded that a sorry fate is in store for Canadian industry under either the status quo or bilateral trade liberalization with the United States. Apparently, increased access to the US market and the removal of Canadian exporters' incentive to locate plants below the border to secure access there would do nothing to stem the decline in Canadian manufacturing that Rotstein foresees.

Optimistic views

The conference speakers supporting the liberalizing initiative tended to be more optimistic about the investment effects. Crispo argued that those branch plants whose sole reason for existence is to avoid the tariff would tend to disappear on both sides of the border,[3] with a resulting gain in efficiency. Other branch plants would remain.

Alton Cartwright was optimistic about the ability of Canadian firms to compete in an open US market and, by implication, about the future of investment in Canada. After giving some examples, he observed that he has discussed the issue with many Canadian business people; symptomatic of their attitudes was 'the fact that all the major Canadian business associations have published endorsements of trade negotiations with the United States'. (Indeed, it is interesting that none of the pessimists at the conference addressed the issue of reconciling with their own prophecies of doom the enthusiasm of the majority of Canadian business people for Canada/US free trade.)

Simon Reisman also discussed the competitive ability of Canadian business. First he observed that in a few industries existing American firms have an edge over their Canadian counterparts, which are smaller and more oriented to local markets. He would cope with this problem by 'transitional measures to allow the weaker partner time to upgrade' and perhaps also by providing adjustment assistance. He noted, 'this technique was built into the Auto Pact and enjoyed a good reception and a considerable measure of success.'

Like Cartwright, Reisman referred to the belief of the majority of Canadian business people that they can succeed in open competition with American firms. Furthermore, he observed that, even in the traditionally sheltered industries, such as clothing, footwear and furniture,

> one can find numerous examples of Canadian firms that have been able to find a profitable niche in the export market – usually . . . for a novel or specialized product.

Like Crispo, Reisman noted that free trade would result in the closing of some foreign and Canadian-owned enterprises that exist solely to serve the local market under tariff protection, but he argued that the persistence of many foreign-owned firms in industries in which the tariff is now zero shows that free trade would not necessarily lead to a mass exodus of foreign firms from Canada. What would occur, he said, would be 'changes in product mix, more specialization, longer runs, and increases in scale'. These are certainly the changes that were observed to follow from the Kennedy Round of tariff cuts, and no reason has been put forward to suggest why the reaction to further tariff cuts should be fundamentally different.

More details on investment

Several papers devoted space to a fuller study of the investment effects of freer Canada/US trade. They made fascinating reading. Rodrigue Tremblay first analysed the problem using standard Heckscher-Ohlin theory – surely the proper starting place for any economist asked to consider this problem. He showed that the theory predicts further Canadian specialization in resource-based industries, to the detriment of Quebec and Ontario and the benefit of the rest of the country. But he then cited the crucial assumptions on which this prediction is based and quoted empirical evidence that they are not realized in Canada. When he added these new facts to the model, the total gain to Canada increased and the prediction emerged that central Canada would gain from free trade with the United States.

Richard Harris was concerned mainly with the employment effects of trade liberalization. His paper included what was, without a doubt, the most interesting number in the entire conference, at least from the viewpoint of political economy. This was his estimate that the short-term effect of free trade with the United States would be a 5.5-per-cent increase – yes, *increase* – in employment (due mainly to trade-diverting effects). Given the propensity of Canadians to evaluate policies almost exclusively on the basis of their short-term effects on employment, this number is extremely important. It answers the fears of those who argue that freer trade with the United States might offer benefits in the long run but the short-term costs would be too high to be acceptable. Since everyone agrees that longer-term adjustments must take place in any case, surely they would be much less disruptive if they occurred when employment was rising under the effects of trade liberalization with the United States than when employment was static or falling under the effects of the status quo.

In considering the distribution of the benefits of productivity increases between capital and labour, Harris put his finger on the main assumption whose incorrectness vitiates any conclusions reached from the traditional Hecksher-Ohlin model – the assumption of the immobility of all factors of production including capital. Harris correctly noted that capital is highly mobile internationally and went on to point out that this fact fixes the return to capital and guarantees that most of the gains of increased productivity would go to labour. He also cited evidence from other studies that 'in the process of raising productivity of Canadian industry, substantial investment would accompany industry rationalization'.

The one paper whose theme was the topic of investment was Ed Safarian's. It was a rich paper that should be studied carefully by anyone interested in this issue. Its analysis and reliance on evidence was impressive. Since it defies quick summary, I will content myself with two observations. First, its reasoned analysis of the behaviour of multinationals contrasted strikingly with the assertions made by the pessimists. Second, it provided a reasoned case against the fears expressed by the pessimists, correctly establishing that

> The onus of proof must rest on those who believe that neither Canadian nor foreign firms – not even those that are already

> on the spot with existing facilities – would utilize the opportunities [shown by much carefully collected evidence to be] offered by free trade for rationalization.on the spot with existing facilities – would utilize the opportunities [shown by much carefully collected evidence to be] offered by free trade for rationalization.

A GENERAL-EQUILIBRIUM VIEW

Another main theme of the conference that I have picked out is the need for a general-equilibrium view of the world. Many of the worries expressed about unfavourable outcomes of freer trade with the United States were based on a partial-equilibrium view that takes existing costs, prices, and exchange rates as given. Of course, these things cannot be taken as given; in fact, a flexible exchange rate is the ultimate protection against some of the disaster scenarios. What would happen, for example, if Canadian manufacturing industry found that it just could not compete and our exports fell dramatically while there was an associated flight of capital from Canada? The answer is that the exchange rate would fall until Canadian industry could compete and it no longer paid capital to flee the country. For example, many firms that could not export with a 75-cent dollar would find doing so profitable with a 65-cent dollar. Despite some suggestions to the contrary at the conference, a free-trade agreement with the United States would certainly be instituted in the context of a flexible exchange rate.

Dick Cooper was using a general-equilibrium framework when he pointed out the common American error of blaming the US trade deficit with Japan on Japanese protectionism. Instead, he said, 'The overall US deficit is due to an imbalance between US investment and US savings (the latter includes the dissaving implicit in the federal budget deficit).' If these macro factors were in balance in the United States, Japanese trade restrictions would result in an exchange rate at which that country's exports were curtailed to the same extent as its imports.

The exchange rate as an equilibrating mechanism

John Helliwell's paper was an important contribution to considering the exchange rate as a mechanism of general-equilibrium adjustment.

Helliwell showed that in the long term, exchange rates are dominated by current-account considerations, with purchasing power parity (PPP) providing the best explanation of these rates.[4] This is the sense in which the exchange rate guards against disaster scenarios. It ensures that Canadian exports cannot, en masse, be priced out of foreign markets. But he also showed the dominance of capital movements in determining short-term departures of exchange rates from their long-term PPP rates. As present American experience illustrates, major capital movements can cause a country's currency to be overvalued for quite a long time, to the consequent discomfort of its export- and import-competing industries. Notice, however, that such an overvaluation requires that the country be an *importer* of capital. But in the disaster scenario following Canada/US liberalization, capital flees Canada. This would drive the Canadian dollar below its PPP rate and so encourage our export- and import-competing industries.

Notice that although capital movements can cause exchange rates to diverge from their PPP levels, the rates can still fluctuate to equilibrate some current-account shock. This point is important because one often hears arguments such as: 'It's all very well to say that the exchange rate can act as an equilibrating mechanism, but it does so only when it is not being dominated by capital movements so that it is at or near its PPP rate.' This statement is not correct. The equilibrating mechanism acts through *changes* in the exchange rate, and these can occur whatever the relation between the actual rate and its PPP value.

Let me give an example. Suppose that the United States, with its need to import capital unchanged, had a sudden increase in domestic costs that priced its exports out of all international markets. The actual exchange rate would fall until the current-account deficit was reduced to its previous level. The exchange rate would have fulfilled its role of adjusting to the shock of increases in domestic prices in spite of the fact that it was not at the level needed to produce a balance on the current account. Similarly, whatever the current capital flows into and out of Canada and, therefore, whatever the relation between the actual and the PPP exchange rates for the Canadian dollar, a sudden fall in Canadian goods' competitiveness on international markets would result in a fall in the exchange rate until our competitive position was restored.

If the strength of such general-equilibrium mechanisms were appreciated, much of the nonsense in the present debate on trade liberalization would no longer be uttered. The reader is left to identify the many places in the papers delivered at the conference in which the reasoning was partial and ignored the existence of general-equilibrium adjustments that would necessarily occur in the postulated circumstances.

SOVEREIGNTY ISSUES

One of the great Canadian worries is that closer association with the United States would cause a loss of Canadian sovereignty. As several of the conference speakers observed, this issue cannot be considered rationally without an appreciation of the base case. Canadian freedom of action to follow some of its traditional subsidy policies is currently and severely threatened by the United States' increasingly vigorous application of its countervail laws.[5]

Simon Reisman frankly admitted to feeling uncomfortable in this 'noneconomic area'. But he concluded:

> I have not been able to find convincing evidence to support these contentions [that Canada would lose political and cultural sovereignty as a result of freer trade with the United States], although I have tried over many years to follow the debate. It is not easy to penetrate the emotion, the dogma, the doctrine, and at times the fervent religiosity that permeates the discussion. I have not been able to discover a basis for these views in theory, logic, analysis, or precedent. You either believe or you don't.

Crispo emphasized the base case, which he points out already includes major restrictions on our ability to make our own policy decisions. He is not sure that a free-trade arrangement would worsen the situation. Instead, he observed, the threats to Canada's policy independence might prove greater under the status quo than under a free-trade arrangement. In the latter case, our access to the US market would be protected by treaty and not, therefore, available to be used by the United States as a bargaining chip in any disagreement over current Canadian policy. Wonnacott and Daly agreed with Crispo.

On the related problem of the need for policy harmonization, Wayne Thirsk argued for omitting subsidization policies from any international agreement with the United States. However, his case depended on subsidies' being 'stable or changing very slowly' so that they 'do not impose adjustment costs on other countries'. Unfortunately, such policies do change, and changes do impact on particular industries, so it seems to me that a policy of benign neglect would not work. Rather, the two countries engaged in free-trade talks should negotiate a range of acceptable subsidies.

A clear and rational approach to sovereignty issues was also found in two important conference papers on negotiation issues, one by John Jackson and one by Gary Hufbauer and Jeffrey Schott.

Opposing views

The conference's opponents of free trade were more extreme in their views. For example, Cliff Pilkey told us, 'Canada's sovereignty would be seriously eroded and ultimately destroyed by the effects of free trade with the United States.'

Abe Rotstein listed as aspects of the sovereignty he thought we would lose:

> No industrial policies that could be construed as subsidies, no voluntary import or production quotas that threaten the interests of American firms, no exchange-rate manipulations, and no significant tax-rate deviations.

What can one make of this list? Canada's ability to use subsidies as industrial policies, which is currently threatened, might be enhanced by a trade-liberalizing agreement (see Lipsey and Smith 1985). I can find no argument, even of the superficial sort, in Rotstein's paper for his assertion about quotas. As for exchange rates, a fluctuating exchange rate is, of course, a fundamental adjustment mechanism, but exchange-rate manipulations, except of a very short-term nature, have been rare in Canadian policy. In any case, exchange rates can be manipulated in more than one way, and some are impossible to prohibit and police. Tax harmonization is an important problem, but asserting an extreme answer does not advance the debate very much. In the base case, Canada is already severely restricted in its independence of policy – as is any small, open economy. In the formation of a free-trade area, there are identifiable forces that would increase Canadian independence in tax matters and other forces that would diminish it (Lipsey and Smith 1985, 124-7). Which way the balance would go is a difficult question that requires research rather than assertion.

Bruce Wilkinson's was the most detailed and thoughtful paper devoted to the case for a major loss of sovereignty. If Canadian negotiators take it as a cautionary tale of the worst possible scenario, it may have a salutary effect. Dire warnings, if carefully reasoned, can be useful in pinpointing pitfalls to be avoided.

Wilkinson seemed to me, however, to go to extremes in his argument that annexation by the United States could result from creating a free-trade area. To support this contention, he cited the cases of the German Zolverein and Hawaii. Wilkinson's argument deserves to be met in detail – and the resulting debate will doubtless add to our understanding of these complex issues. In the meantime, I will observe briefly why I think these examples are not relevant to the present case.

German unification is the story of the triumph of Prussia. The Zolverein shows that a state committed to political unification with other states can use a trading association as one of its tools. But for this example to be relevant to the case at hand would require that the United States be as determined about political unification with Canada as was Prussia about the unification of the German states. This suggestion seems to me to deserve the ridicule that it invariably gets when I mention it on US platforms. In any case, as John Crispo observed, 'Assuming the true nature of the United States is this diabolical, it is unlikely that Canada could resist any such determined overtures – even if it stayed out of any free-trade arrangement.'

The example of Hawaii raises somewhat different issues. This was a case of annexation, as Wilkinson observed, at the outset of American offshore imperialism. Again it illustrates that a strong state bent on annexing a weak one can use trade policy as one of its weapons. But to take American imperialism of the late nineteenth and early twentieth century as a model of current American behaviour seems to me to be bordering on the ridiculous. We might as well assume that when the United Kingdom offers aid to some developing country in 1985, it is seeking to add that country to the list of British colonies. American behaviour in Hawaii was, in my view, deplorable, but I do not see

American senators intent on annexing Canada any more than I see them anxious to annex another Mexican province. They have enough political problems without upsetting the domestic balance with ten new states of dubious political allegiance.

CONCLUSION

The conference raised several other important issues, but space precludes me from mentioning them. My general impression is that had I been a visitor from outer space whose first experience on earth was the conference, I would have suspected the organizers of stacking the deck to put most of the appeals to established theory and systematic evidence on one side of the overall question and most of the pure assertion and emotive appeals on the other. But I know the organizers, and I do not believe they did this. So I am led to suggest that if those who oppose free trade with the United States have hard analysis and solid data to support their pessimistic views, some agency that knows of this evidence should organize a conference at which it can be presented for public scrutiny.

NOTES

1 At present, a subsidized Canadian export to the United States is countervailable even if the competing American product receives an equivalent domestic subsidy.

2 Murray Smith and I have criticized this policy package elsewhere, so I will not duplicate here the arguments that led us to conclude that 'the inward-looking option seems so risky that we can only wonder if its authors have thought out its full international implications' (Lipsey and Smith 1985, 62).

3 A rising number of successful Canadian exporters are establishing branch plants in the United States to avoid existing and anticipated American barriers to trade.

4 The PPP exchange rate between the Canadian dollar and foreign currency shows the number of Canadian dollars needed to purchase, in Canada, an average mix of goods and services that would cost one unit of the foreign currency if purchased in the foreign country.

5 In our recent book, Murray Smith and I have tried to consider the various arguments for the loss of political and cultural integrity in more detail than is usually done. We do not pretend to have said the last word on these issues, but we do hope to have taken them

beyond the realm of mere assertion and into that of reasoned argument and discussion. See Lipsey and Smith (1985, chap. 6).

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